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COMMUTER TAX MORATORIUM BILL

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

FIRST SESSION

ON

S. 800

JUNE 13, 1989

Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE
26-143 WASHINGTON : 1990

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U S Government Printing Office, Washington, DC 20402

S361-16

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COMMUTER TAX MORATORIUM BILL

TUESDAY, JUNE 13, 1989

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 11:00 a.m., in Room SD-215, Dirksen Senate Office Building, Hon. Donald W. Riegle, Jr., presiding.

Also present: Senators Moynihan, Bradley, Riegle and Symms.

[The press release announcing the hearing follows:]

[Press Release No. H-27, May 23, 1989]

FINANCE COMMITTEE ANNOUNCES HEARING ON COMMUTER TAX MORATORIUM BILL

WASHINGTON, DC—Senator Lloyd Bentsen (D., Texas), Chairman of the Senate Finance Committee, announced Thursday that the Committee will hold a hearing on S.800, a bill that provides for a moratorium on and study of certain State tax laws relating to the taxation of nonresidents.

The hearing is scheduled for *Tuesday, June 13, 1989 at 10 a.m.* in Room SD-215 of the Dirksen Senate Office Building.

OPENING STATEMENT OF HON. DONALD W. RIEGLE, JR., A U.S. SENATOR FROM MICHIGAN

Senator RIEGLE. Let me invite all those in the room to find seats if they will. Let me initially invite our three colleagues, Senator Lautenberg, Senator Dodd and Senator Lieberman to take seats at the witness table.

Last evening we had Hearns and Leonard. Today we have Bradley and Moynihan.

The hearing this morning is to examine Senate Bill S.800, a bill introduced by Senator Bradley and co-sponsored by all four New Jersey and Connecticut Senators. That Bill responds to a New York State law enacted in 1987 affecting how nonresidents of New York compute their New York State taxes.

Under the new law, the New York State tax bracket for nonresidents is in effect determined by looking at all of their income, not just income earned in the State of New York, although the New York State tax is still imposed only on that portion of the income actually earned in the State of New York. S.800 would impose a moratorium on this New York legislation as well as on a bill introduced in the New Jersey legislature in response to the New York law. During the moratorium, a commission would study these laws and the moratorium would end after the commission completed its study.

This is an important issue for three important States and we have very distinguished witnesses here today, including the Governors of Connecticut and New Jersey. So we will be hearing very strong representation on both sides of this issue. The Committee very much looks forward to hearing the testimony today and I believe that the hearing will prove useful to the Committee as it considers S.800.

Let me now call on Senator Moynihan for any opening comments he wishes to make.

OPENING STATEMENT OF HON. DANIEL PATRICK MOYNIHAN, A U.S. SENATOR FROM NEW YORK

Senator MOYNIHAN. I thank you, Mr. Chairman, for holding this hearing. It is not every day we get three such distinguished Senators before our Committee. I regret that they come here in support of something so manifestly unconstitutional. [Laughter.]

Senator MOYNIHAN. And legally forlorn. But they shall be followed by Mr. James Wetzler, whose counsel we accepted as credo in this Committee for many years, who will describe in painful detail just how wrong it all is. But it's an election year in many of our States and that is what this is all about.

Thank you, Mr. Chairman.

Senator RIEGLE. Thank you, Senator Moynihan.

Senator Bradley.

OPENING STATEMENT OF HON. BILL BRADLEY, A U.S. SENATOR FROM NEW JERSEY

Senator BRADLEY. Mr. Chairman, I would like to make a little lengthier statement about the Bill and I want to thank all of the witnesses for coming today—the three Senators, of course, and Governor Kean and Governor O'Neill, a special thanks for making the effort to come.

I would like to just briefly describe the Bill and why I think it is necessary. In 1987—I will not say in the dark of night, though I think that is how a lot of people in New Jersey and Connecticut see it—but certainly with no warning and no consultation, New York changed the way it taxes out-of-state residents. The change took effect in 1988.

Prior to 1988, New York, in calculating its tax on nonresidents, did not take account the taxpayers' non-New York income. Beginning in 1988 they changed the law to adopt a global concept of income, also known as the California method. Under this new concept, New York includes not only wages earned in New York by nonresidents, but also any non-New York wages, along with interest and dividends. The effect of this surprising change is to raise taxes on nonresidents relative to past years.

New Jersey and Connecticut reacted to this unfair and unexpected tax hike with understandable anger. New York was initially quite unrepentant, leaving Connecticut and New Jersey State legislatures no choice but to adopt retaliatory tax measures of their own. A full-scale border tax war would be in the offing. This would be really unfortunate because it will create uncertainty for taxpayers and I think crimp our regions potential for growth.

Enter S.800. It addresses the unfairness and surprise of New York's law. It does so by imposing a three-year moratorium on the implementation of the new tax. Second, it addresses the problem of the escalating border tax wars by placing a similar moratorium on retaliatory measures by neighboring States. Third, it addresses the very real need to correct the situation and to avoid its repetition. It does so by setting up a tri-state commission to advise Congress on the most equitable solution to the current impasse and by creating a model for future consultation and cooperation.

New Jersey, New York and Connecticut are one region. We all have a compelling interest in the lowest possible taxes and the strongest regional growth. We all have a compelling interest in acting toward each other as good neighbors in good faith. We need community and partnership, not biggar-thy-neighbor competition in which there are no winners and only losers. This means more and better consultation, especially on tax matters where people's feelings naturally run very high.

That is what this Bill does. It promotes a good-neighbor policy by setting up a mechanism that will facilitate the search for a fair and speedy end to confrontation. I am frankly pleased that by the mere introduction of this Bill, there seems to have been a positive effect. I understand that New York has already conceded that at least two of the more egregious provisions in the new law should be repealed. These are the surcharge and the formula for calculating tax on pensions and interest on municipal bonds, that both of which has resulted in unjustifiable tax hike on retired persons.

I hope that the New York State legislature does indeed repeal these unfair and unreasonable provisions. They illustrate, I think, why laws should not be enacted without thorough debate and scrutiny by the people whom they affect. Had there been that kind of consultation I am advocating in S.800, these mistakes need not have happened.

So again, Mr. Chairman, let me welcome the witnesses. I hope the hearing sends a clear message that the people of New Jersey, myself included, feel very strongly about the New York law and its inequity and that it has got to be changed in some way; and that there has to be better cooperation and more consultation; and that the people of New Jersey and Connecticut deserve a fair deal.

Senator **MOYNIHAN**. Mr. Chairman, may I just make one response to that?

Senator **RIEGLE**. Of course. Senator Moynihan.

Senator **MOYNIHAN**. That I very much agree with the tenor of Senator Bradley's remarks. I do not doubt that it is the case that New York will want to modify its statutes to remove any inequities in consultation with its neighbors. We consult routinely in a dozen of things.

I would even so address the first point I made and I think Senator Bradley probably feels this way in some sense. This is an appropriate subject for a Federal hearing but not for Federal legislation.

Senator **RIEGLE**. Thank you, Senator Moynihan.

We have three distinguished colleagues with us this morning and we will be pleased to hear from them in order of their seniority in the Senate, which means that we will hear first from our colleague, Senator Dodd.

STATEMENT OF HON. CHRISTOPHER DODD, A U.S. SENATOR FROM CONNECTICUT

Senator DODD. Thank you very much, Mr. Chairman, and Senator Bradley, Senator Moynihan.

I am delighted to be appearing this morning with my two colleagues—my colleague from Connecticut, Senator Lieberman, and my colleague from New Jersey, Senator Lautenberg. Sitting behind us, of course, are our respective Governors. Governor Kean I had the good fortune of seeing in my State of Connecticut on Sunday. We were attired a bit differently than we are here this morning, but nonetheless we always welcome him passing through our State.

Senator Bradley has outlined, I think, very clearly the fact situation that leads us to this hearing this morning. While I do not disagree with our good friend from New York that this is a matter for Federal discussion, not necessarily a matter of Federal legislation, we are really left with no other recourse it seems to me at this juncture as a way of trying to achieve some form of consultation.

There are many people in my State of Connecticut, as I know there are in New Jersey, who would like to take a much harsher measure that would pass a constitutional test. We have many fine people from the State of New York who spend a great deal of time in our State, in Connecticut, and we are very proud of that and would like to come up with creative means by which they might levy additional taxes on our visitors in the State. So I think it is in our interest to try and find a formulation here that will avoid that kind of a contest or war, as it has been called.

Let me make two points, if I may, and then I just ask unanimous consent that my statement, Mr. Chairman, be included in the record.

Just to put some flesh on the fact situation as clearly explained by Senator Bradley. Prior to 1988, of course, we know the State of New York taxed nonresident commuters on the portion of their income earned in New York at the tax rate applicable to all people with that amount of income.

To set an example, to make this clear for people—a Connecticut commuter whose taxable income in New York was $6,000 and whose spouses taxable income in Connecticut was $28,000 would pay New York taxes on the $6,000 earned in New York at the 3 percent tax rate applicable to all people with that amount of taxable income in New York. Thus, under the old law, a Connecticut commuter would pay $180 in taxes. That is prior to the passage of this law.

By contrast, under the new law that took effect on January 1, the same Connecticut commuter would still be taxed on the $6,000—but here is the difference—but he or she would pay the tax rate applicable to a couple with the $34,000 of income. That rate is 8.375 percent—one of the highest in the country, if not the highest—thus, the new law requires a tax of $502 on the $6,000 earned in New York, or nearly three times the old tax. Now that is the problem.

Let me tell you what makes it worse. What makes it worse is this tax falls on lower and middle income folks. It does not really affect the very affluent in my State to any great degree. Inasmuch as New York law reaches its maximum marginal rate at $34,000 of taxable income, the new law will have little affect on wealthy commuters because they are already paying the maximum tax. The people who will be hurt the most are those with small incomes, for whom an additional $320 a year can be a very important amount of money.

So in addition to being inequitable, it falls inordinately heavily on those who can least afford it as a result of this.

So I commend my colleague from New Jersey for coming up with, I think, a solution that makes some sense. It is balanced. The temptation certainly was to introduce legislation, as has been introduced, which would penalize New York or come up with some harsher measures. But this is a reaching for a conciliatory approach to the problem. I commend him for it and I am delighted to be joined in that effort by our colleagues from New Jersey and my colleague from Connecticut this morning, Mr. Chairman, and I will be glad to yield the floor.

Senator RIEGLE. Thank you, Senator Dodd, and we will make your statement a part of the record—your full text a part of the record.

[The prepared statement of Senator Dodd appears in the appendix.)

Senator RIEGLE. We would be pleased now to hear from Senator Lautenberg.

STATEMENT OF HON. FRANK LAUTENBERG, A U.S. SENATOR FROM NEW JERSEY

Senator LAUTENBERG. Thank you, Mr. Chairman, members of the Committee. I, too, want to add my welcome to our distinguished colleagues from the State Houses of Connecticut and New Jersey, particularly our distinguished Governor, Tom Kean. It is kind of an anomaly to be sitting across the table from such good friends—the one in the middle from New York State, and with whom I rarely disagree, having to say today that this is a disagreement that I hope will not push us to the mat but that we are going to examine with a degree of thoroughness. It may be constitutionally appropriate, but it may be regionally inappropriate.

We are inextricably bound together—all three States under discussion today—and whatever we do that disturbs a compatible relationship is just not going to be good for us. Those of us from New Jersey—I will speak only for my State—who have a concern, have a deep concern. I had a bitter discussion with one of my constituents who happens to be my daughter, who commutes to New York and she has decided against marriage as a result of this. Not really, but it has been a bitter discussion. [Laughter.]

Senator LAUTENBERG. We cannot ask for exemptions that would be unfair. A recent change in New York State's tax law has put a terribly unfair burden, as we have heard, on over a quarter of a million New Jersey people, and other nonresidents, who work in New York. Under the new law, income from the sources outside the State is considered in determining the rate of New York's State tax that nonresidents owe on income earned in New York.

Mr. Chairman, New Jerseyans are outraged by this new tax and for an appropriate reason as I see it. New York's law may be constitutional but it is fundamentally wrong and unfair. I want to be clear at the outset. I have no problem with New York State taxing income that is earned in the State, that is their right. What is not fair, though, is basing New York's tax rate on income earned outside of the State.

Why, for example, should a New Jerseyan have to pay more taxes to New York State solely because he or she has a spouse who happens to make money in New Jersey or elsewhere. A secretary from New York who earns $15,000 in New York, and whose spouse works as a firefighter in Hackensack, New Jersey is penalized. Under New York law, the secretary's $15,000 would be taxed the higher rate simply because of the firefighter's income. Yet, the firefighter has absolutely no functional connection with New York and does not enjoy a single benefit from that State's government.

That is not right and that is why people from New Jersey are so outraged. If someone from New Jersey works in New Jersey, then that person's income, simply put, is none of New York's business. Too many in New Jersey think that our State should retaliate, tit for tax, I can understand those sentiments.

But in the long run, it does not make sense to get into a war between the States over this issue. We have too much at stake, whether it is a cleaner environment or better transportation, as our distinguished senior colleague from the State of New York knows, we work on so many things together to ensure the ability of our region to be competitive and to work together. So, in this case, it does not make sense for New Jersey or Connecticut—and it sure is not going to make sense long term for New York. The States in the region, there are just too many common interests—regional economy, as I said, transportation and environment.

We should be working together and never, if it's avoidable, fighting each other.

Mr. Chairman, this Bill presents a sensible mechanism for resolving the commuter tax problem in a manner that meets the needs of New Jersey and Connecticut commutes and that I hope will eventually be acceptable to New York by establishing a three-year moratorium. This would provide a needed cooling off period. During that time, the New Jersey taxpayers would be relieved from the penalty under the New York law. By establishing a commission with equal representation from each of the States involved, the Bill provides a mechanism for resolving this dispute reasonably and fairly.

I appreciate the opportunity, Mr. Chairman and colleagues, to testify here before you. I look forward to working with members of the Committee to help secure prompt passage of this legislation. Thank you.

Senator RIEGLE. Thank you, Senator Lautenberg.

Senator RIEGLE. Senator Lieberman.

STATEMENT OF HON. JOSEPH I. LIEBERMAN, A U.S. SENATOR FROM CONNECTICUT

Senator LIEBERMAN. Thank you, Mr. Chairman, Senator Moynihan, Senator Bradley. I appreciate the opportunity to join my colleagues before the Finance Committee on this matter and particularly to welcome Governors Kean and, of course, our own great Governor and my friend, Hon. William A. O'Neill.

Mr. Chairman, I had promised my senior colleague from Connecticut that I would try to restrain myself and to be less florid on this occasion than I was when we announced the submission of this Bill. But Senator Lautenberg's reference to his daughter makes it impossible for me not to refer again to this New York legislation as taxation by cohabitation. That is something that all of us should frown upon.

Mr. Chairman, we speak lightly because we are friends, but I can report to you and to Senator Moynihan that people in Connecticut who commute to New York to work are outraged by this tax; and the outrage is not simply because of the extra dollars that they are spending. There is a sense that this is unfair. It is as simple as that—a sense that it is unfair to tax them based on income that is not related to the income they earn in New York.

One of the historic justifications for taxation is that it is an attempt by government to recover the costs of delivering services to the citizenry. One of the tests of taxation has always been that those who are taxed must have some minimal contacts with the jurisdiction that is taxing them. This basic notion is undercut by the New York legislation. The reality is that once we begin to open the door that this legislation opens, we go down a path that brings us to division.

The truth is, as I believe Senator Dodd said, there are loads of commuters who come the other way—from New York to Connecticut everyday. Just travel along I-95 northbound and see the flow of traffic in the early morning hours and the other way in the late afternoon commuting hours. We in Connecticut feel that our friends in New York actually impose costs on our government, not only by commuting to Connecticut, by the air pollution they send to our State, and by the partially treated sewage that they send into Long Island Sound. Those arguments are based on fact, but they are arguments that we really do not want to make.

What I fear is, that the New York tax legislation drives a wedge into the harmony and cooperative spirit that has traditionally prevailed in our region when we deal with common problems—such as the environment, transportation, and economic development. That is why I think S.800 and the work that Senator Bradley and the rest of us have done on it is a measured and moderate response to the problem.

We can argue about the constitutionality of the New York legislation. But I believe it is clear that S.800 is itself constitutional. That is, we in Congress have the authority to impose this moratorium and to try to give a commission the opportunity to bring some peace, rationality and hopefully some continued progress to our region.

So I thank you, Mr. Chairman, for giving us this opportunity. We take this Bill very, very seriously and I hope we can move it through this Congress.

Senator RIEGLE. Thank you very much, Senator Lieberman.

[The prepared statement of Senator Lieberman appears in the appendix.]

Senator RIEGLE. Gentlemen, we appreciate your testimony. Let me just raise one question with you, and that is, you are all asking for a Federal intervention here. It seems to me that it is quite unusual to ask the Federal government to step into a dispute between States. You have certainly put the case facts on the table.

But how do we—I would like your thinking as to how we establish standards to decide when the Federal government is to intervene in situations like this or other situations that might arise. I can foresee situations, for example, that might be undertaken by the State government of New Jersey or Connecticut that some other adjacent State might take objection to. Should we view that as something that is right for the Federal government to step into? I mean, do we really want to go down that road?

I would like your thinking as to how we judge on a broader base this question of when individual States come to the Federal government and ask the Federal government to come in and try to deal, and in a sense assert an authority over a dispute between two States.

Senator DODD. Well, I would say, Mr. Chairman, first of all, I would say it seems to me the appropriate and proper forum when you have that kind of a conflict between States. They are out of the courts, obviously, but as it has been pointed out I -- we will hear later this morning testimony that the New York law is constitutional. There is differing opinion on that. But for the sake of argument, let us assume that that is correct. So that the courts really provide very little relief in this situation because the argument would be whether or not New York had the constitutional right to levy a tax as they have. Arguably, they have.

But that does not address the fundamental question that Senator Lieberman raised and that is the issue of fairness and the possibility of constitutional laws that would levy taxes on the residents of New York who come to Connecticut, either to work or use services of our State or the State of New Jersey.

What we are trying to do here is to approach this in an equitable environment. That is to seek equity here. The Federal law that we are seeking here is the only means by which we can achieve that. Obviously, were there some agreement to sit down and try to resolve this in an informal environment then that might be the case, but efforts along those lines have not been successful.

So when States—when there is a conflict between States, as there is here—then this becomes the only available means by which we can address that problem as it came to us. So it is an appropriate forum in our view.

Senator LAUTENBERG. Mr. Chairman, I think that it is fair to say that there are many cases where the Federal government has to intervene in disputes between States, whether it is the enforcement of existing law or the establishment of new law. In this case, there is a question that I think should be resolved, at least to allow review. In the process of developing the legislation you are going to have hearings. You will listen to testimony from experts. Give this commission a chance to meet.

And meanwhile—And I think that there is a willingness, I understand from the State government in New York, to forego, for instance, a surcharge that was there. So there has already been a change in view and perhaps as we go through and review expert information, testimony that we will find a way through this.

But I think it is perfectly appropriate for the Federal government to review this in contemplation of the passage of law.

Senator RIEGLE. If I may just say—and then I would like to hear from Senator Lieberman—why wouldn't another normal and more, perhaps, immediate remedy in a case like this be for the Governors of the respective States to sit down and talk? They obviously are colleagues, they serve in a body of Governors; they are adjacent State Governors. Why is that not an appropriate forum?

We will hear from two Governors a little bit later, but it still seems odd to me that a matter of this sort cannot in some fashion be addressed between the States directly without asking the Federal government to intervene as a kind of referee. It may well be that the facts in this case suggest that as a remedy, but I am trying to put that in some broader context because it seems to me we could have the Federal government asked to intervene in endless numbers of disputes.

Senator Lieberman, you wanted to comment.

Senator LIEBERMAN. Yes, Mr. Chairman. I think we should leave it to the Governors to respond directly. My understanding is that there have been attempts at communications and they have not resulted in substantial changes. But I will certainly leave it to Governor Kean and Governor O'Neill to respond.

I would like to respond briefly to your question about the standards for intervention by the Federal government in a situation like this. In one sense, as my colleagues have indicated, what we are asking for really goes to the heart of why the Federal government was formed—to prevent the States from acting as independent sovereignties, competing and conflicting with one another.

I would set two standards—one practical and one constitutional. The practical one is where the Federal government can play a constructive role as a mediator—as a source of alternative dispute resolution—and that is basically what we need now. We are at a standstill. There is a rising level of fury in New Jersey and Connecticut; there is a rising pressure on elected officials at the State level to take retaliatory action against New York. The Federal government can play a positive role by coming in through S.800 and trying to calm this down.

Secondly, I would say the Federal government should enter where a Federal authority is implicated or involved. In my opinion, the Commerce clause is involved here. We are talking about the free flow of commerce among the States. And this tax, I believe, amounts to a burden on that free flow and justifies Federal intervention in the very restrained ways provided for in this Bill.

Senator RIEGLE. Thank you.

Senator Moynihan.

Senator MOYNIHAN. Could I ask Mr. Lieberman——

Senator RIEGLE. Please.

Senator Moynihan. —who is a former Attorney General and a person of great learning in the law and held in great respect in this body. We have, it seems to me, two questions here. How do we sort them out? This, I think, is a good occasion to try to do it. One is, what is wise? What is political? What is equitable among neighbors and many interrelated interests.

The second is, however, what is constitutional? And teach a layman here because I ask to be instructed. Is it not the case that some 14 States now do this—now follow the New York method of scrutinizing total family income—husband and wife income, basically, which is what your remark about taxation by cohabitation means?

I do not know if each State's particular method has been tested in the courts, but I believe the original case—and here I am way out of my league—was *Maxwell* v. *Bugbee*, which was 1919, in which the Supreme Court upheld New Jersey's right to impose a progressive inheritance tax and to include in the amount of estate assets owned outside of New Jersey. I think that sort of set the rule. I look to my lawyer friends for that.

If that is the rule, that presumably—although you do not know these days—will continue to be the rule. The Supreme Court has surprises for us on most Monday mornings it seems to me. But assuming that is the case, then the question becomes how do you bring about an appropriate conciliation and negotiation. Do you really think a statute can do it? Would a statute not lead to 5 years of litigation?

Senator LIEBERMAN. Obviously, your question requires a preliminary comment—which is that I consider myself your student, not your mentor. But let me say this: On the question of the New York law, I think the constitutionality is arguable. It is a close case. I understand that.

But what I want to contend this morning is that S.800, which seeks to put a moratorium on that New York law, is constitutional itself. In other words, we may argue about whether what New York has done is constitutional, but I think it is clear that we have the authority in Congress to step in and say, fellows, let us hold it up for a while and see if we cannot work something out.

I raise the Commerce Clause, in response to the Chairman's question, as a policy basis for Congressional intervention. We are dealing with commerce here among the States in a very real way. I am sure there is a quote from Hamilton here that would support our desire to keep that free flow of people and commerce between these three States going, unburdened by taxation by one State.

Senator MOYNIHAN. Thank you. I do thank you.

Senator RIEGLE. Senator Moynihan, did you want to pursue your question period now?

Senator MOYNIHAN. No, sir. I just wanted to be instructed as I have been.

Senator RIEGLE. Very good.

Senator Bradley.

Senator BRADLEY. Thank you, Mr. Chairman.

I would like to get the witness' judgment, really, on the question of constitutionality. There are clearly different aspects of the New

York law. Some are on much dicier constitutional grounds than others. For example, a wide body of opinion would say the surtax is unconstitutional, without any question. There are now cases that are moving through the courts. How long they are going to take one does not know. But they are asserting the unconstitutionality of the entire New York law and of aspects of the New York law.

That creates a great deal of uncertainty. Senator Lieberman asserts there is a Commerce clause involved here. At a minimum, what it creates is bad feeling among the States, which is not in the interests of any of the States. And so, wouldn't you say that what we are really looking for, and the commission and the moratorium being the means to achieve that, maybe not the only means, but the means to achieve that, is some reconsideration ofa law hastily entered into aspects of which are clearly unconstitutional, the totality of which is genuinely unfair. Isn't what we are really asking for is some reconsideration, some more sober assessment of the impact of these kind of emotions enacted in the dead of night and the impact they will have on our prospects for regional growth?

Senator LIEBERMAN. Absolutely. I could not have said it better myself.

Senator DODD. Well, I think a point that Senator Lieberman raised a moment ago is very important. Senator Moynihan has certainly been—if not the leader—one of the leaders over the years in this effort. It would be impossible in the time remaining this morning to recount the instances where we must work together—these three States. We have the largest single concentration of humanity on the face of the globe. It is concentrated in the Metropolitan area of New York. This is not Nevada and California we are talking about here.

There are 450,000 commuters every day that move between those three States, primarily going to the City of New York. The issues of environment, of transportation, of jobs, employment, are just staggering in their proportions. It is vitally necessary that these three jurisdictions work as closely as possible together. It is essential for the well-being of all three jurisdictions.

What has occurred here—albeit if we want to argue constitutional, if the courts so decide that, and I think Senator Bradley has indicated that may not be the case—but for the sake of discussion, let us assume it is. Is it worth winning the point on a legal technicality—the constitutionality of a particular statute—to sacrifice the goodwill that must exist between these three States and the resolution of matters that are very important to all three States—all six members of the Senatorial delegation and all three Governors.

So I would suggest that we may be winning—a battle may be won here on a constitutional argument and a far larger set of issues will suffer as a result of that. I think that is evident in our respective legislatures where we have seen, I know—and the Governor of our State does—we have had bills introduced by members of the State Senate and State Assembly. I think that is true in New Jersey as well. That kind of bad feeling does not portend well for the relationships between the three States.

Senator LAUTENBERG. I guess it is impossible to legislate good feeling and harmony. But that is maybe a by-product of what is going to come out of this. I just ask our distinguished Governors behind us to be sure—I knew that Governor Kean had had discussions with the Governor of New York State—Mario Cuomo—whether there had been any progress and he will have a chance to amplify that—but he indicated quickly, no. So did the distinguished Governor of Connecticut.

So we are looking out of frustration to another way to deal with the problem. The constitutionality issue, you know, I am the only non-lawyer here and I am looking at three non-lawyers up there. We are going to fight this out on some kind of fairground we hope because there is too much at stake. There is the animus that builds from taxing people working in New York State, coming, living—having to live elsewhere because either they choose to bring their children up in their environment or they cannot afford the high costs of living in New York State or matters of such kind.

The fact is, it does not do any of us any good. I frankly think it will serve to drive business out of New York which has to be of necessity a high cost area. And when people say, hey, listen, I do not want to go to work there, the whole of America is fighting with the problem of labor shortage—of skilled people—being able to find the kind of talent that we need to go to work. Well, if you drive them out, they will find other places closer to home. That has been happening.

There are more jobs. There is more intrastate travel in Connecticut and New Jersey than there ever used to be because people can find what they want to do within the border. So we hope that this will be the beginning of the smoking of the peace pipe. If we have to do it under the umbrella of the U.S. Congress, so we should do it.

Senator RIEGLE. Gentlemen, thank you very much.

Senator Bradley, anything else for you at this point?

Senator BRADLEY. No, I would like to just thank the witnesses for their testimony.

Senator MOYNIHAN. As would I.

Senator RIEGLE. We thank our colleagues.

Let me now call to the witness table Governor Kean of New Jersey, Governor O'Neill of Connecticut, and as well, Hon. James Wetzler, who is the Commissioner of the Department of Taxation and Finance for the State of New York.

Senator MOYNIHAN. No, wait. I think the Governors are alone.

Senator RIEGLE. Let me just have the Governors present at this point, if I may. Excuse me, I misspoke.

Gentlemen, we welcome you. It is not often that we have the privilege of having Governors appear before us and it is a special pleasure to have two outstanding Governors present today. We are delighted to have you here. It sounds as if, to really round out this debate, we might well need your colleague from New York who, of course, is not here. But he is ably represented, as your State is, by both our colleague, Senator Moynihan and the Tax Commissioner, who will testify shortly.

We are very pleased to have you, Governor Kean, we would like to hear from you first, please.

STATEMENT OF HON. THOMAS H. KEAN, GOVERNOR, STATE OF NEW JERSEY

Governor KEAN. Mr. Chairman and to Senator Bradley, Senator Moynihan, I want to thank you very much for the opportunity to be here this morning. As many of you are aware, the phrase "the war between the States" usually refers to the American Civil War. But lately, in New Jersey at least, people are starting to use it to describe relations between New York and its neighbors, Connecticut and New Jersey.

The most recent unpleasantness between the States involves, of course, this decision of New York's to what we believe unfairly tax and unwisely, also, we believe, tax out-of-state residents on the basis of their entire family's income and not just a portion of their income that is earned in the State of New York. We have got a lot of outrage in New Jersey and I cannot blame the people who are outraged.

There is talk of all sorts of things. There are newspaper articles about urging New Jersey, and then letters, to boycott New York stores and restaurants and not buy goods out of New York. Our legislature has prepared a whole series of retaliatory bills that are of "an eye for an eye, a tax for a tax" kind of atmosphere. But I understand it, I mean, I understand why.

New York has enacted really a silent tax—hike on New Jersey voters and it is going to cost them $50 million approximately—more than they pay now. That increased taxation, of course, was done without any representation. It was done unilaterally, without any hint, without any discussion, without any calls among State officials, without any discussion or provocation whatsoever. There was no New Jersey advocate or Connecticut advocate that was given a chance to argue against this before it was put in place. No New Jerseyan, obviously, had a chance to vote against it and 213 years ago we fought a war to end that kind of treatment.

This tax hike affects real people, who have to meet real challenges and they have to pay real bills. I am not talking in the abstract. Let me give you one example of a real person who wrote me. This is a New Jersey man and he works in New York City as a doorman. He has for years. He makes about $16,000 as a doorman. His wife is a school administrator back in New Jersey and his wife makes $42,000. Instead of being taxed at the rate applicable to $16,000, this doorman is going to have to pay taxes as if he earned $58,000 and did it all in New York.

He used to owe New York $521 a year. But thanks to this unfair, and I think unjustified, tax hike, he is going to pay New York $904. That is a 74 percent tax increase. That is a lot of money for a man who makes $16,000 a year.

What makes it worse, of course, is that it is not fair. New York has said that since New Jerseyans use New York services, they should pay for them. I agree with that. I agree with that; they should and they do. But the New York tax scheme does not follow this logic. Instead it taxes New Jerseyans as if they use those services all of the time instead of just some of the time.

Let me give you another example. Let us say two co-workers are working side by side, a Ms. Smith and a Ms. Jones. They work side by side at the same firm; they earn the same salary of $30,000. Ms. Smith is single and she lives in New York. Ms. Jones is married and lives in New Jersey and let us say the spouse works in the home town and also makes $30,000. Ms. Smith, who uses New York services 100 percent of the time, will pay New York taxes at a much lower rate than Ms. Jones who uses New York services only 25 percent of the time. The difference is startling and a bit dismaying.

I am very pleased that New Jersey's Congressional delegation has been so vigilant. I commend Senator Bradley and the other members from New Jersey and Connecticut and members of the House delegation because every one of them has written Bills and tried to address this in one way or another. Our delegations have moved quickly and moved thoughtfully.

I want to thank our regional neighbors from Connecticut who are represented here by a great Governor—Governor O'Neill—for joining us in this fight against its unjust tax. These Bills share a common purpose—to relieve oppression of this particular tax. This Bill we are talking about now, Senator Bradley's Bill, represents a step toward reconciliation, not retaliation. It gives us a time to pause and reflect before any further action is taken. It prevents similar actions by other States, at least for the time being. We do not seek conflict; we do not want confrontation.

In fact, Senator Bradley's approach seeks very thoughtfully to avoid any further confrontation. Provision for a moratorium will help cool the ardor for retaliation that is basically, I will tell you, is sweeping our State.

I think it was 173 years ago Chief Justice John Marshall wrote, "The power to tax is the power to destroy." This is something that is often quoted. While circumstances may be slightly different today, the truth of Marshall's action is still valid. The New York tax represents an attack on regional cooperation and, therefore, I believe on regional prosperity. New York and New Jersey have gotten along very well over the past few years. We have negotiated an historic series of agreements that have helped both States. Noticeable, we collect sales tax for each other. We have agreed to use Liberty Island revenues for the homeless in both States. We cooperate in identifying tax revenues that might be lost in one State or the other through tax evasion.

These agreements have been talismans of cooperation. New Jersey's unilateral tax hike threatens every one of these agreements.

Senator **Moynihan**. You mean New York.

Governor **Kean**. Pardon me?

Senator **Moynihan**. New York.

Governor **Kean**. Yes, the unilateral tax hike threatens those agreements that we are talking about and threatens any further cooperation, of course, to get more agreements.

"We hold so much in common," has been said in New York, New Jersey and Connecticut, in an era in which we have seen a national competitiveness grow. Leaders on both sides of the Hudson realize the greatest economic rivals we face are really across the ocean; they are not across the river.

I am pleased to see that Governor Cuomo has announced a plan to scrap the surcharge on New Jersey taxpayers. That is a start.

But it is only a start on an area that we believe is patently unconstitutional anyway. New York and New Jersey need each other very much. To impose a patently unfair tax upon New Jersey is to drive a wedge between our two States.

Like good neighbors—New Jersey, New York, Connecticut—should be able to solve this dispute, but up to this point the resolution has proved difficult if not impossible. Senator Bradley and his colleagues have suggested a fair and equitable solution. We welcome your assistance.

But this is not the first time that the proper relationship between the States has been debated. I think it was around 200 years a great New Yorker wrote, "An unrestrained intercourse between the States themselves, will advance the trade of each by an interchange of their respective production, not only for the supply of reciprocal wants at home, but for the exportation to foreign markets."

That I think is the quote that the Senator was looking for from Alexander Hamilton. I believe also it comes from Federalist 11. But it was no more true then than it is today. The less burdens placed on interstate commerce the better off we are all going to be. No burden is heavier than an unfair tax. Those Federalist Papers, of course, from Hamilton were a message to the people of New York. We would like to send a message also to the people of New York of a different kind. We believe this tax is unfair; we believe it is unproductive; we believe in the end, like a boomerang, it will come back and hurt the City worse than it will hurt anybody else. And we hope that Hamilton's message will be heard again today.

Thank you very much.

Senator RIEGLE. Thank you very much, Governor, for a fine statement and a very thoughtful statement.

[The prepared statement of Governor Kean appears in the appendix.]

Senator RIEGLE. You know, it is nice that when we have disagreements, we still try to deal with them in a civilized way. It is much appreciated.

Governor O'Neill, we are delighted to have you and we would like to hear from you now, please.

STATEMENT OF HON. WILLIAM A. O'NEILL, GOVERNOR, STATE OF CONNECTICUT

Governor O'NEILL. Thank you, Mr. Chairman, Senator Moynihan, Senator Bradley. I certainly am proud and happy to join Governor Kean in opposing the New York tax that reaches across the borders of our States to tax New Jersey and Connecticut families alike. Moreover, it is always a pleasure to be with our good friends, Senator Dodd and Senator Lieberman, who I thought their points were very well taken.

Senator Bradley, your Bill, which has been cosponsored by Senator Lautenberg, Dodd and Lieberman, recognizes the regional problems that can occur when neighboring States get involved in crossborder taxation and the inevitable consequences—unproductive tax disputes. Connecticut residents this Spring have been adversely, and in my opinion, unfairly affected by changes in New York's State income tax. There is no question about it.

For New York had formally taxed income earned by Connecticut residents working in New York. Certain changes in 1987 to the tax laws extended the reach of that to our unearned income from outside the State of New York. I do not dispute the rights of a State to tax the income of nonresidents earned within that State, even though Connecticut does not tax earned income at all. What I do dispute is the right of a State to reach for income earned out of the State by nonresidents of that State, or the use of out-of-state income as a basis for increasing the tax rate in which in-state income is taxed.

The issue of a State's ability to tax is one of fundamental fairness. Connecticut, like every other State, uses its tax dollars to provide much needed services to its residents and for others. I strongly believe that the taxes paid should have a rough relationship to the use of State services.

During this period of time when many States are struggling to meet the costs of providing programs and services to its own citizens, it is especially intolerable for residents of Connecticut to be asked to pay a disproportionate share of taxes for New York services. I believe the issue here goes beyond dollars and cents. The issue here is also one of fairness and Federalism.

While New York points to the fact that for the moment their tax changes have reduced the overall tax burden on every paying its income tax, that discounts the fact that it may be attributed unfairly to begin with and the tax is always subject to increase.

If this moratorium is approved, it is clear Connecticut and New Jersey residents will be paying a smaller proportion for New York services than they are today. Let me state for the record, I understand the attraction of taxing nonresidents. It is politically appealing. However, we in Connecticut decided against a retaliatory commuter tax aimed at New York residents who work in our State. While we said no this year, I cannot guarantee you that we can continue this stance in the future years if the problem with New York's tax is not readdressed.

Governor Cuomo recently informed me that he will seek technical changes to his State's law that will stop taxation of unearned income in our State, and possibly refund to some taxpayers money that should not have been paid to New York's complicated tax system to begin with. I commend him for that. It is a good first step, but only a first step.

Nevertheless, it is appropriate to stop this process of cross-border taxation before it leads to a destructive relationship where regional cooperation is always necessary if we are to provide a full array of services to all the residents that live in the region. Legislation like New York's can only erode those relationships and make cross-border tax wars more likely.

As Connecticut's Governor, I firmly believe our State has been responsible in raising from its citizens the taxes it takes to provide the services for Connecticut residents, as well as maintaining our transportation networks for others who drive through our State. Retaliatory taxes such as the ones considered by our General Assembly are really designed for retribution, not as revenue measures. That is not something I would like to see. But we are human and we all could get frustrated. No State should be subject to intrusions from other States against citizens whose hard earned tax dollars should fund services within their own State.

In conclusion, I would like to make it clear that as Governor I usually would not request the Congress of the United States to interfere in State tax matters. However, in this case, Congressional action provides the only effectual recourse for a just resolution of this argument between the States. I urge your Committee to take favorable action on the Bill.

I also wonder, out loud, perhaps, whether an initial mistake was made to begin with with this particular tax bill that was formed and drafted in Albany. Could it have been possible that when they were drafting it, someone in the drafting made a mistake and now no one can retreat from the position that was done to begin with. Maybe that might be something to think about.

I know that perhaps all of us in this room have made a mistake once in awhile. I think I made one back in 1948 or 1949. I cannot recall what it is now. [Laughter.]

Governor O'Neill. But those things happen. And maybe, just maybe pride of authorship might be stopping a solution that could be forthcoming in this particular piece of legislation. I would like to think that. I would like to see people retreat from their positions and readdress the situation. This moratorium might give us time to do exactly that.

Thank you, gentlemen.

[The prepared statement of Governor O'Neill appears in the appendix.]

Senator Riegle. Thank you both very much. You made very fine statements and very persuasive arguments. Obviously there is another side to the debate that we have not heard as fully yet. Hopefully the Commissioner of Taxation from the State of New York will round that picture out a bit.

But I would like to pose to each of you a question similar to the one I posed to our three Senate colleagues. That is, it is quite unusual to ask for a Federal law that in effect reaches in and undoes a State law—in this case a State tax law. That is what the Bradley bill would do. It would suspend the effect of the 1987 New York tax legislation here, and it has other aspects to it. Let's say, just hypothetically, the case facts would support that, that there is an equity argument here and for whatever the reasons just in a hypothetical sense maybe the weight of argument is on your side.

But again, what is the broader principle that we ought to establish here as to deciding when the Federal government properly should intervene and set aside a State law. Now I know—Governor Kean, you have had a very distinguished record and you obviously have very strong feelings about what you undertake to do within your State. I do not know that you much like the notion of the Federal government coming in unless it is on the basis of some very clearly defined set of ground rules. I am sure the same is true in Connecticut.

So how do we establish some broad standard of intervention here that is really quite extraordinary? I mean it is really quite an extraordinary step to be seeking, it seems to me.

Governor **Kean**. We would never, I do not think, as Governors, ever ask for Congressional help if there was another way to solve a problem to begin with. And secondly, we would never want you to interfere in our internal affairs unless they were affairs that were beyond our control. This is taxation without representation and I think there is a fairly broad tradition in this country of asking the people's representatives to intervene when that takes place.

We, after all, joined the Federal compact in New Jersey, in part, because of a large neighbor who was imposing tariffs at that point on our goods. There is, I think, a very long tradition of when there is something the States cannot resolve among themselves to come here to our representatives and say that broadly, that we have tried to resolve it, that we cannot. We think it is patently unfair and, therefore, we come to our representatives, sitting as a whole, and say we think this is unfair. We are not able to handle it. It is not within a State, but between States, which is one of the very things I believe the Federal compact was set up to solve.

Senator **Riegle**. Governor O'Neill, did you want to add a thought or two to that?

Governor **O'Neill**. Well, I feel the same as Governor Kean does, of course. That we do not like to come here because we do not like the Federal government intruding. However, there is no recourse that we see at this particular point. We have discussed this with our counter part, the Governor of New York, with no real redress to the issue. And not having any redress from that particular standpoint and being locked into the position we find ourselves in at this moment, where else do we go?

Senator **Riegle**. Well, I do not necessarily want to have you play out here the discussions you had with Governor Cuomo because you should not be obligated to try to give his side of the argument and he certainly can speak for himself. But there was a reference by our colleagues earlier, Governor Kean, that you apparently had had an exchange that was less than warm.

Governor **Kean**. No, it has always been warm. I will tell you, I think Governor Cuomo and I honestly get along better, probably, than any two Governors who have ever represented our two States. We get along well on the political level; we get along even better on a personal level.

Senator **Riegle**. But I take it on this issue he has a very sharp disagreement, is that right?

Governor **Kean**. Yes, it is just disagreement. I am not breaking any secrets to say Governor Cuomo said to me nothing in private that he has not said in public. His stand is as hard, or as firm, in private as in public. I think that is probably the same thing you have found, Bill.

Governor **O'Neill**. that is true.

Governor **Kean**. And without that, if I felt there was some way that we could resolve it among ourselves then we would not be here. We would try to resolve it among ourselves. We only come to the Congress for a dispute between States when resolution between the States becomes impossible.

Senator **Riegle**. So is it fair to say then, in your discussions with Governor Cuomo, that you have discussed this at length, directly, all the arguments we have heard today have been exchanged back and forth and the two sides are just locked in opposing positions? Is that——

Governor KEAN. No, that would not characterize my discussions. They have not been lengthy. We have not had a chance to expose all the arguments because their position has been firm. As you know, when you get into a discussion and one person takes a very firm position it is very difficult then to continue the discussion of additional arguments.

Senator RIEGLE. I guess what I am trying to establish here is, I think to have the basis for a Federal intervention, it would at a minimum be necessary to know that discussions have broken down. That there is an impasse and that obviously further discussion on that kind of basis does not appear as if it is going to lead to any kind of a resolution here. Do I take that to be your judgment?

Governor KEAN. Yes, that is my judgment. If there were any chance of getting this tax substantially changed by negotiations or talks between the three Governors, I would not be here.

Senator RIEGLE. Senator Moynihan.

Senator MOYNIHAN. That, Mr. Chairman, was—I was disappointed here, but not least because the respect that Governor Kean knows that he has held by this Senator in this Committee with whom he has been such an extraordinary help in welfare legislation last year, for example.

It is a rare thing to hear a public person with the care and precision and concern of Governor O'Neill speak of a measure as intolerable. Intolerable is a strong word and you do not use such words very often. I am not sure that message has really reached New York.

I have to say that, sir.

Senator BRADLEY. It will now, I guess.

Senator MOYNIHAN. It will now, as it is no doubt now doing. I do think that, you know, we have the—we hear the Chairman trying to deal with the problem of just constitutionality. We have that problem. We also have this problem of comity and good sense.

But I want to thank our Governors and tell them how much we respect them and appreciate their coming to us.

Senator RIEGLE. Senator Bradley.

Senator BRADLEY. Thank you, Mr. Chairman.

I think that the mistake that you are referring to, Governor O'Neill, is that in the legislation anywhere the names New Jersey or Connecticut appear it was meant to be New York.

Senator MOYNIHAN. Printers do that all the time.

Governor O'NEILL. It would be a totally fair Bill if that were the case.

Senator BRADLEY. The question of intervening and voiding a State law—the legislation really does not do that. It does not set aside the State law. It simply says, this is going to be a cooling off period. The law will not go into effect in the cooling off period so that all parties can think together with the counsel of the commission and ultimately come to what we think is our collective senses and not escalate further, but simply isolate, and in this reconsider on New York's part. We would hope. The commission would give advice on that. That is really done to avoid more invasive action by the Federal government. This is not invasive action. This is a cooling off period and a commission, as I contemplated the legislation.

I think that each of you have given outstanding testimony. I was particularly interested in your argument, Governor Kean, on the services question. I mean you do not really think about that very often. But as I take it from your testimony, the result of the Bill will be that the increase in tax for nonresidents for the use of services will be much less than what the resident New Yorker would be paying making the same income.

Governor **KEAN**. That is absolutely correct. New York's taxes go up and down on a fairly regular basis. As New York's taxes rise again, as I suspect they will at some point, with this as a base, that inequity will become worse and worse.

Senator **BRADLEY**. So that if someone had a $10,000 income in New York and the rest of the income, maybe from another spouse, was $40,000 or $50,000, and the tax rate in New York went up and person making $50,000 maybe formerly was paying 9 percent, might be paying 12 percent, it would be a tax at a 12 percent rate.

Governor **KEAN**. That is absolutely correct.

Senator **BRADLEY**. Well, we hope that when we hear from the witness from New York we will be able to get into a great deal of specifics so that people actually understand how the tax works. But I think your suggestion—your point—was very well taken.

Senator **RIEGLE**. Senator Moynihan.

Senator **MOYNIHAN**. Before our most distinguished witnesses have to leave. Can I ask my learned friend from New Jersey, how does he respond to the celebrated dictum of Oliver Wendell Holmes that, "the power to postpone is the power to negate"?

Senator **BRADLEY**. I think that is the motto of the U.S. Senate. [Laughter.]

Senator **RIEGLE**. Gentlemen—Senator Moynihan, did you have a rejoinder?

Senator **MOYNIHAN**. I would have to go back to Holmes to find another one.

Senator **RIEGLE**. Just one final thing before we finish with our Governors here and that is this: I would say to you Governor Kean, is the notion that the Federal government should in effect suspend a State law. The idea of the Federal government saying, look, we are not sure, we are uneasy, we will suspend the State law and we will take a look at it and we will have a commission and the clock will run and so forth.

That seems to me to be quite a different approach, if you will, than someone who said, we think there is a problem here. We want to try and change it. So let us have the commission; let us not try to suspend the State law, because in a sense if you come in and interdict the actions of the State then obviously it can happen in New Jersey, it can happen in Connecticut, it can happen in Michigan, or any other place.

I am not a lawyer with the background that would let me know the number of times in which a Federal action has been taken where it has reached in and said to a State, we are in a sense taking away your authority to act in that area. We are suspending a State law for the time being. I just wonder, are you really comfortable with that notion. You may very well be in this case, but I am not asking you just with respect to this case, but I mean the general proposition. Is that really a sound way to go as a matter of general practice?

Governor KEAN. I am never comfortable with the Federal government coming in, for any number of reasons. But after all, we have State laws suspended all the time—often by the courts but certainly by a Federal presence of some sort.

Senator RIEGLE. But I think an act of Congress is quite different, is it not?

Governor KEAN. Yes. Congress is quite different. I would be happier, frankly, in the hands of the U.S. Congress these days than I would be in the hands of the courts. I think when it does come to a question of relations between the States, you have got to remember, I think, why we were formed and how the constitutional convention progressed. And the idea that there were then all sorts of problems between the States, and particularly between large States like New York and then a very small State like New Jersey.

It was Governor O'Neill's State, really, that made the Federal compact work by coming up with a compromise. But it was all set up to resolve disputes so that we did not have border wars, and tariffs and taxes, and all of that between the States. This is very different.

People talk about the California experience. This is very different than the California law. The California law is not a commuter tax. It does not tax people that way. The California law is very different. It simply taxes a retiree, for instance, on income coming from a company in another State. This is a new and different extension. I suppose if it is left alone people will start doing it all over the country who need income in difficult times and it is going to create all sorts of troubles on various borders.

Big States can do it easier to small States because they have more—you know, more clout.

Senator RIEGLE. Have your researchers been able to find for you—or maybe you even know from your own knowledge and memory—where the Federal Congress has acted to intervene and in a sense set aside a State law on a temporary basis and to put a commission in its place to decide if it is a fair law? Are you aware of any other instance in modern times when that has been done?

Governor KEAN. I am not. But I have no problem with the U.S. Congress setting precedents of this kind because I think they are based on historic experience. They are based on the experience of the country, and they are based on the United States Congress—the people's representatives—trying to solve a problem between States.

It is very different if this was simply upsetting a State law, affecting the people of one State. This is very, very different. This is taxation passed without any representation. In this case, without any notice even, without any consultation and in which we have absolutely no regress, other than to come to our elected representatives. I think that is the case which I would make for coming and asking you whether or not you will be of help.

Senator BRADLEY. Mr. Chairman, you asked a question that deserves an answer. The question was, did the Federal government ever do what this law contemplates? The answer is yes. In 1959, public law 86-272, where exactly what this contemplates was done.

Senator **Riegle**. Tell us—I mean, just give us a sense as to what that did.

Senator **Bradley**. It is relating to the power of the States to impose net income taxes on income derived from interstate commerce and authorizing studies by Congressional committees of matters pertaining thereto. It essentially is the same thing—saying setting aside certain laws that were passed and establishing a commission.

Senator **Riegle**. Well, I am not familiar with that case.

Senator **Bradley**. I am not sure that this is not a debate that we need to have now. But we will put it in the record, at least. I would like for it to be in the record.

[The information follows:]

Appendix I.—P.L. 86-272—THE INTERSTATE INCOME LAW

TITLE I.—IMPOSITION OF MINIMUM STANDARD

SEC. 101. (a) No State, or political subdivision thereof, shall have power to impose, for any taxable year ending after the date of the enactment of this Act, a net income tax on the income derived within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person during such taxable year are either, or both, of the following:

(1) the solicitation of orders by such person, or his representative, in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection and, if approved, are filled by shipment or delivery from a point outside the State; and

(2) the solicitation of orders by such person, or his representative, in such State in the name of or for the benefit of a prospective customer of such person, if orders by such customer to such person to enable such customer to fill orders resulting from such solicitation are orders described in paragraph (1).

(b) The provisions of subsection (a) shall not apply to the imposition of a net income tax by any State, or political subdivision thereof, with respect to—

(1) any corporation which is incorporated under the laws of such State; or

(2) any individual who, under the laws of such State, is domiciled in, or a resident of, such State.

(c) For purposes of subsection (a), a person shall not beconsidered to have engaged in business activities within a State during any taxable year merely by reason of sales in such State, or the solicitation of orders for sales in such State, of tangible personal property on behalf of such person by one or more independent contractors, or by reason of the maintenance of an office in such State by one or more independent contractors whose activities on behalf of such person in such State consist solely of making sales, or soliciting orders for sales, of tangible personal property.

Senator **Moynihan**. I might say, just because we are trying to work this out—and I think the spirit is clear.

Senator **Bradley**. Yes.

Senator **Moynihan**. That is truly the case—the precedent. But it did not set aside *one* State statute, it set aside *all* State statutes of a particular type.

Senator **Bradley**. Yes.

Senator **Riegle**. And I think that is precisely the point I was driving at. I think there is the question of whether that is a practice we want to establish. I also wonder even if we have the capacity to do that because I think we might be invited to come in and do some fine tuning on State laws all over the country and not just tax laws.

To my general knowledge, to have not done that. We have not gone in and said to a State that is having a dispute with another

State, look, we would like to—we are just going to act and set your law aside temporarily. That seems to me to be quite different. I mean, if we are doing that to all the States at once, you know, that is a different kind of a situation. But to get into a dispute between States, I think is something different and it deserves, I think, very careful thought before we start down that road.

Governor KEAN. I would agree with you. It deserves very, very careful thought. I would only suggest that this is the camel's head inside the tent. I presume if this is allowed to stand and States need revenue very badly, you will see it popping up in other parts of the country. You will see the same kind of ill feeling. Other people will be down here. I think Senator Bradley's suggestion that perhaps this is the time to look at it, to give it some thought, to try and get together and see whether we cannot come up with an amicable solution and that the U.S. Congress may have a part in that process is probably the right step.

Senator RIEGLE. Very good. Gentlemen, thank you very—Did you want to add something Governor O'Neill?

Governor O'NEILL. Only to say that I feel the same as Governor Kean. We do not like the intrusion any more than you would if we were trying to intrude upon the Federal government. However, there is no recourse that we can see at this moment because of basically a stone wall that we find ourselves at that is not moving. We would like to get some movement there.

Senator RIEGLE. Very good. Gentlemen, thank you very much. We are very pleased to have had you this morning.

Senator BRADLEY. Thank you very much.

Senator RIEGLE. We will just pause one minute before our next witnesses are called to the table.

[Whereupon, a recess was taken and the hearing resumed at 12:18 p.m.]

Senator RIEGLE. The Committee will come back to order and let me invite those that wish to remain to find seats. Let me now identify our——

Senator BRADLEY. Mr. Chairman, let me say that I think it is unfortunate, I do not think the TV crews should leave before the next witness testifies.

Senator MOYNIHAN. The New York crews are remaining.

Senator RIEGLE. Mr. Wetzler, we welcome you and we appreciate your important responsibilities as Commissioner for the Department of Taxation and Finance for the State of New York. We are very interested in your testimony. We appreciate your being here this morning.

Of course, you have had the occasion now to listen to others, make the other side of the argument. There is always a certain order in which things come. So you come late in the list of witnesses, but your point of view is certainly as important as any other that we have heard and so we are anxious to hear it.

STATEMENT OF HON. JAMES W. WETZLER, COMMISSIONER, DEPARTMENT OF TAXATION AND FINANCE, STATE OF NEW YORK, ALBANY, NY

Commissioner WETZLER. Thank you very much for having me testify. It is good to be back at the Finance Committee after almost a 5 years' absence. I am a little out numbered at this hearing. I take refuge in the famous statement from Williams Jennings Bryan that "One man, when clad in the armor of a righteous cause, is stronger than all the hosts of error."

Senator RIEGLE. Let it be said, too, for the record, that you served in an outstanding way previously as the Deputy Staff Director to the Joint Tax Committee, and so you are certainly familiar in these precincts and we are delighted that you are back here with us today.

Commissioner WETZLER. Thank you I have a statement I would like to put into the record if that is okay.

Senator RIEGLE. Without objection.

Commissioner WETZLER. I will just give a summary and try to deal with some of the issues that have been raised by the previous witnesses.

First of all, our view is that there really is no problem here that requires Congressional action in the sense that New York has made changes to its tax law that are legal, that are widely used in other taxing jurisdiction, and that, taken together, provide very substantial tax cuts for our nonresident taxpayers.

From having heard the previous witnesses, you probably would not have guessed that the law we have enacted has, in fact, provided very substantial tax reductions for New Jersey and Connecticut taxpayers who earn income in New York. But that is the case, and we are going to demonstrate that.

Secondly, were there a problem, we do not believe that S.800 is a very good solution to that problem. I will go into some reasons why I think that is the case as well.

Let me begin by describing what New York's tax reform and reduction program has accomplished. As you know, Congress enacted, under Senator Bradley's leadership and, indeed, the leadership of the Finance Committee, a major tax reform in 1986. That broadened the tax base. New York, like many other States, conforms its State income tax base to the Federal tax base. So the tax reform, absent any other changes, would have provided a revenue windfall to New York State through our conformity with the Federal base broadening.

New York decided that it was going to provide tax cuts to offset that. What we did is, in 1987, enacted a tax reduction and reform bill that first of all provided tax reductions to give back the windfall that otherwise we would have received from Federal tax reform. But we went further than that. We actually enacted some tax reform at the State level. That involved further broadening of the State income tax base, and rate reductions to offset that. And then still more rate reductions to provide a very substantial net tax reduction.

The net tax reduction, when it is fully effective in 1991, will be providing tax cuts at an annual rate of $4 billion a year. This year, 1989, the third year of the five year program, the net tax reduction—that is net of the New York reforms and net of the Federal windfall—is around $2.5 billion.

Some of those reforms were very helpful to nonresidents. One of them was what is called income splitting, which was designed to deal with the marriage tax penalty. It was interesting that Senator Lautenberg referred to his daughter's concerns. Governor Kean referred to an example where two spouses have equal incomes—one in the State, one out of the State—and compared that tax burden with a single person's.

In reality, the income-splitting feature of our law deals with those issues and creates a State tax law that has only a very small marriage penalty, and in many cases almost none. I go into that in somewhat more detail in my statement. The top marginal tax rates before the tax bill were 9 percent on earned income and 12 percent on unearned income, and the tax bill reduces those rates to 7 percent by 1991. That is from a maximum of 12 percent on unearned income all the way down to 7 percent. This year the top tax rate for both types of income is 7-7/8 percent.

So the tax reductions are very dramatic. There was an increase in the standard deduction, which takes the poor people off the tax rolls, that was up to $13,000 for a married couple—a higher amount than the Federal standard deduction.

Now we think it is wrong for our critics to separate reform and reduction. If there is one Senator who should know the linkage between those two, it should be Senator Bradley, who pioneered that concept at the Federal level. Now, on balance, our cuts, net of the reforms, provide substantial tax cuts to nonresidents. In 1989, the current year, nonresidents taxes will be reduced by $180 million below what they would have been had we not enacted this law in 1987. That is fully proportional to the tax cuts being received by residents.

So when people talk about what an outrage this is and how we started a border war in the dead of night, I think it is worthwhile to keep in mind that nonresident taxpayers, as a group, are receiving substantial tax reductions. Not everyone is receiving a reduction. For both our residents and our nonresidents, perhaps 10 to 20 percent of the taxpayers have tax increases; the other 80 to 90 percent have reductions. But on balance, looking at nonresidents as a whole, there is a very substantial tax cut. I think that is important to note.

Despite our adoption of the California method of apportionment, the reason why nonresidents still get a proportional tax cut on average is because other features of our law disproportionately benefit nonresidents. My statement goes into those features of the law in greater detail.

Now let me discuss the California method. The other witnesses have described how it works, and I need not go into that. The basic reason we think it is appropriate is because it is fairer. If I have a taxpayer who earns $10,000 of income in New York and has $90,000 of other income, why should that taxpayer be given the benefits that are designed to reduce taxes for poor people. It is clear that it is only appropriate for New York to tax the income earned in New York—the $10,000. But why should that taxpayer be treated like a poor person and have that $10,000 treated as if that taxpayer has no outside income.

Keep in mind that while people have quoted examples of two-earner families, those are not the only taxpayers affected. It affects single people; it affects, let's say, accountants in the Big 8 accounting firms who have income from all over the country, and so on and so forth. So we think it is fair.

Fifteen States use the California method. This is not some bizarre new idea cooked up in New York to pick the pockets of our neighbors. Fourteen other States use this method of apportionment—that is out of 45 States who have an income tax, and 41 States who tax nonresidents. New Jersey, as has been pointed out, uses this method of apportionment to calculate its inheritance tax. The Federal government uses this method of apportionment to calculate the foreign tax credit. So this is not some strange new idea. This is a tried and true method of taxation that is used in many other jurisdictions for many other purposes.

There has been some discussion of our stonewalling the other States. I do not think that is accurate. We have conferred. I have conferred with my counterparts in both New Jersey and Connecticut. Governor Cuomo has stated publicly that if our law is having unintended side effects, if it is operating inequitably, we will change it. He asked me to review the law with that in mind. In response to that review, we have come up with some technical changes. Now we call them technical corrections, but the fact is we are talking about $10 million a year out of a provision that without the corrections would have raised $60 million.

So it is not a trivial matter. It is a significant modification of the law that Governor Cuomo has recommended to the legislature. So we think that you need to look at our law in the context of overall reform and reductions. Do not look at the affect of one provision on taxpayers, look at the affect of the whole package—the tax cuts as well. And as I say, there have been very, very substantial tax reductions.

Personally, I think that Governor O'Neill, Governor Kean, and the taxpayers of New Jersey and Connecticut ought to be congratulating Governor Cuomo for having cut their taxes substantially, rather than criticizing him for the one piece of the package that offsets a modest portion of those tax cuts.

Now let me turn now to S.800, the Bill in question. First of all, as I say, I do not think there is a problem here. We have cut taxes. We have done it in a legal fashion. We have done it in a way that is used by many other States. But let us assume hypothetically there is a problem. Is this the appropriate solution? I think the answer is not.

First of all, it singles out New York. None of the other 14 States who use this method would be barred from using it, only us. I think that is unfair. I think it is of questionable constitutionality to single out one State. What you would be saying is, if a New Yorker earns income in California, California can tax that income under the California method of apportionment. However, if a Californian earns income in New York—if the situation were exactly reversed—New York could not tax that person on that income in the same way.

I am not a lawyer either. We did some research. Apparently the Federal government has never tried to limit the taxing authority of one State, singling out that State. So it would be hard to say—I think we would be breaking new ground constitutionally. But I, personally, think there are serious constitutional questions raised by the Bill. I also think it is unfair. It is not fair for the Senate to single out one State.

Secondly, it singles out one part of an integrated package. Senator Bradley's bill does not put a moratorium on the tax cuts, it only puts a moratorium on the tax reform. I think that is a bad principle for the Senate to be establishing because you are going to be coming under some very heavy pressure to look at your own tax reform bill from 1986—the historic tax reform that was enacted under the leadership of this Committee. And if you establish the precedent that we keep the rates cuts but repeal the reform, I think you are going to find yourselves in a lot of trouble later on this year as pressure builds up to reexamine the tax reform bill. But that is exactly what this Bill would require New York to do—to roll back the reform, but to let the reductions stand.

Thirdly, we object to the retroactivity of Senator Bradley's bill. It goes back to 1988. That is last year. We think that would create some administrative problems for us. I would also just point out that in some cases the California method produces a tax reduction, such as in a case where a taxpayer has income in New York and losses out-of-state, this method creates a lower tax; and so in those situations the Bill would require us to impose retroactive tax increases on those taxpayers.

Lastly, I think the Bill sets the wrong standard for Federal intervention to limit State taxing authority. Senator Riegle, you have asked a number of the witnesses about this—about what the standards ought to be. It is clear the Federal government has substantial power to limit a State's taxing authority. But I believe that that should be used very sparingly. It should be used in cases where State taxes interfere with interstate commerce. It should be used in cases where double taxation is occurring—where several States are trying to tax the same tax base. Neither of those situations pertain here.

I am worried that this Bill could become the vehicle for other proposals to limit State taxing authority, a number of which are pending throughout the Congress. By setting lenient standards for when the Federal government should intervene, you make it more likely that these other proposals will get serious consideration. We believe Congress should be moving in the other direction and removing restrictions from State taxing authority and, indeed, we will be coming to you with suggestions on how you can help us collect tax on mail order sales, which is a move in the other direction, the way we think you ought to be going.

What is the proper solution to this dispute? Well, first of all, I think one element of a proper solution is for the political leaders of the affected States to communicate the facts to their voters. The fact here is that nonresidents are getting substantial tax cuts. Yet, I do not think that is getting properly communicated. I think there should be a continued dialogue between the States. As I say, there has been a dialogue; that dialogue has led to our proposing some technical changes in the law.

New York, New Jersey and Connecticut are pioneers in interstate cooperation in administering tax laws. We have the ability ourselves to discuss these matters and to work out solutions where appropriate. To the extent that discussions between the States do not work, I think the courts are the place to make the decision. The law in this area is quite well developed. The law that has been developed by the courts so far makes sense—that these taxes are basically upheld if they are not discriminatory and if they are fairly apportioned.

We believe our law would meet those standards. We think those are really the same standards the Senate would want to apply if it took a look at it.

Finally, I think we ought to get beyond this dispute over what is, in fact, a fairly modest tax question—a very technical tax question—and on to the bigger issues of how the three States can cooperate in making the tri-state region better—both in the area of taxes and elsewhere. We think it is important to get the focus back on the ways we can help our citizens more by cooperating rather than by continuing what is, I think, really a dispute that is unnecessary since we have, in fact, provided very substantial tax cuts to these taxpayers.

Thank you very much.

Senator RIEGLE. Mr. Commissioner, you make a very strong presentation and we have made your full statement a part of the record.

[The prepared statement of Commissioner Wetzler appears in the appendix.]

Senator RIEGLE. I draw from it and I just restate what I take to be the bottom line of what you are saying, that after review by the State taxing authorities in New York, in conjunction with the Governor of your State, that you have decided your position today is that you think the law is sound, it is proper, it is being carried out in a fashion that you had originally intended, and that you are making some adjustments which you think are not inconsequential on the margin to this. But fundamentally your position is that you feel you are on sound ground, you have reviewed it, and you feel that the tax system you have is justified and that the Federal government ought not to intervene.

Is that in essence what you are saying here?

Commissioner WETZLER. I think that is largely correct. However, I am still under direction from the Governor to be examining this law to see whether it has unintended impacts or it operates unfairly. To the extent we learn that that is the case, I think the Governor will make further adjustments.

Senator RIEGLE. Now that is a very important point. So you are saying that this is not a closed issue, that the Governor has instructed you to continue to examine it and further examination is underway and that this is not something that you are in concrete on.

Commissioner WETZLER. Well, you know in the taxing business—and you know this on this Committee better than anybody—nothing is ever closed. Right now we think our method is fair. We have got very sizable tax cuts in place. I know some of the witnesses have said, "Well, that is fine but what if your tax rates go back up." We do not think that is going to happen. We are very proud of our tax cuts. But I am sure if the tax rates went back up, it would be appropriate for the Governor, whoever is the Governor at that time—I do not think they will go back up during the Cuomo administration—and whoever is the Tax Commissioner at that time to take another look.

Nothing is ever closed. But so far, neither the Governor nor I have not been convinced that our law is operating unfairly. In fact, a number of the examples that you have heard from prior witnesses are incorrectly calculated.

Senator, I do not want to be critical of any particular Senator, but Senator Dodd gave an example today which is basically carried over from his press release which shows a taxpayer whose tax would go up to—I think—$502. That example simply fails to calculate the tax accurately. I would like to correct his numbers.

Senator RIEGLE. Let me do this. I am happy to have that. We will put what you have in the record. But I want to establish in my own mind something very clearly, and that is, are you asserting on behalf of the State of New York and, in effect the Governor, that further examination will go on. I take it that what you are really saying is, you like the law the way it is, you feel it is justified, you do not intend to undo it or roll it back or suspend it, but that you feel quite comfortable in the position that you are presently in with respect to your tax system. Is that a fair summary?

Commissioner WETZLER. That is right. We believe our law is fair, particularly when viewed in the context of the overall tax reduction package. To the extent that we become convinced that it does not operate fairly, as with any other part of our tax law, naturally we would be looking at proposals to change it.

Senator RIEGLE. Then let me ask you just one final question and I will yield to my colleagues. I take it then that from the vantage point of the other Governors who were here today, who obviously hold a contrary view, that they have had those discussions with your Governor. There is in effect a basic difference of opinion, that there is an impasse here and that I draw from what I have heard this morning that further conversations between the Governors probably will not change things very much because of the strength of the case that you folks feel you have on the merits of your position.

Commissioner WETZLER. Well, just to be precise, there have been extensive discussions between the Tax Commissioners of the three States. I do not think that the Governors have talked in detail and at lenght—The Governors have exchanged letters. There have been discussions at my level, so I think we understand their objections. I think they understand our case. The problem is that so far, to my mind, the arguments have not been convincing.

Senator RIEGLE. Well, I got the clear impression from Governor Kean that you had in fact talked quite directly with Governor Cuomo about it and that to a—from Governor Kean's point of view, an unsatisfactory conclusion, that there is a fundamental difference of opinion at that level in addition to the difference of opinion that appears to exist at your professional level.

Now if that is not right, I just want to make sure that there is an opportunity to clarify that here. But that is how the cards sit at the moment as I hear this testimony today.

Commissioner WETZLER. Okay. I personally am not in a position to characterize the discussions between the Governors. I was not a party to them so I am not a very good source on that.

Senator RIEGLE. Well, is the description I gave accurate with respect to how it stands with respect to the Tax Commissioners?

Commissioner WETZLER. Yes, that's right.

Senator RIEGLE. Very good. Thank you.

[The information follows:]

Senator Dodd's Example

Married: One spouse earns $6,000 in New York, one earns $28,000 in Connecticut. Senator Dodd's calculation of 1988 tax liability was $502.50.

Actual Tax Liability

Actual tax liability for this sample taxpayer for 1988 is $229 and for 1989 is $216.

Senator RIEGLE. Senator Moynihan.

Senator MOYNIHAN. Mr. Chairman, I would simply want thank Mr. Wetzler for his very able and comprehensive testimony.

I wish to make one observation. You are quite right in your point that this particular legislation in New York has reduced overall tax rates. But I do not feel that is a very relevant fact. The relevant fact is that the Governors of two States have come before this Committee and they said that what you—we have done in New York is, in their view, not fair. The Governor of Connecticut said it was in his view intolerable. That is not the normal language of these careful, moderate, public men.

I would hope that word would reach into your bureaucracy, sir. I say it very bluntly. I used to work in the Governor's office and I know what the Department of Taxation and Finance can be like. I am not sure how much it has changed. I have been 13 years on this Committee and I have never before had the experience we had this morning.

I do not believe, Mr. Chairman, that older members would know of it either--Mr. Bentsen or Mr. Matsunaga or Mr. Packwood. That was an extraordinary event. It requires more than a technical response. But I am sure you understand that anyway.

Thank you, Mr. Chairman.

Senator RIEGLE. Thank you, Senator Moynihan.

Senator Bradley.

Senator BRADLEY. Thank you very much, Mr. Chairman.

I think Senator Moynihan has made a clear point, as usual. I would like to try to put some flesh on a statement that you made. When you described the value of the technical corrections at about $10 million, could you break those out for us? How do the technical corrections meaning those things that you have looked at and you felt were unfair and merited changes, get to $10 million?

Commissioner WETZLER. Keep in mind, that is $10 million for all nonresidents, not just $10 million for New Jersey.

Senator BRADLEY. Oh, no. I understand that. The total amount raised is about $50 to $60 million.

Commissioner WETZLER. Well, I think it would be $60 million without the technical corrections and $50 million with.

Senator BRADLEY. So what are those changes that you have recommended?

Commissioner WETZLER. The two changes that the Governor is recommending to the legislature—one of them involves the surcharge that we have on unearned income.

Senator BRADLEY. Okay.

Commissioner WETZLER. Which applies for 1988.

Senator BRADLEY. Right. And you are recommending what?

Commissioner WETZLER. It takes the surcharge out of the calculation so that we would be only applying the surcharge to unearned income of nonresidents that is sourced in New York. Let's say you have a gain on the sale of property in New York or interest income received in connection with a business located in New York.

Senator BRADLEY. So that you would rebate that?

Commissioner WETZLER. Yes. We are proposing that that be retroactive so that the affected taxpayers could file for refunds.

Senator BRADLEY. I see. What is that amount?

Commissioner WETZLER. That is much of the $10 million. I am not sure of the exact number.

Senator BRADLEY. And then what is the other thing you are recommending?

Commissioner WETZLER. The second one deals with the way the allocation fraction is computed. Our method of taxation consists of two steps. First of all, a nonresident calculates his or her taxes as if he or she is a resident and secondly, multiplies that tax by a fraction—the numerator of which is New York source income, the denominator of which is total income.

Senator BRADLEY. Right.

Commissioner WETZLER. Today that fraction is computed based on Federal income concepts—Federal adjusted gross income.

Senator BRADLEY. Right.

Commissioner WETZLER. What we are proposing is to have that fraction be computed with the New York modifications, so that income that is taxed under the Federal government but exempted in New York would be excluded from the calculation of the fraction, and income that is taxed in New York but excluded at the Federal level would be included in it. The main effect of that will be on pensions because New York provides very generous treatment for pensioners. And so excluding pensions from the fraction will be very beneficial to people who live out-of-state but receive pensions from New York sources.

Senator BRADLEY. So that the second change that you relate goes to the unfairness that exists in the law now, in which someone who gets a New York pension ends up paying more tax that you think upon a second look is really fair?

Commissioner WETZLER. That is right.

Senator BRADLEY. So you expect to change that?

Commissioner WETZLER. Yes. We are proposing to the legislature, and we at the moment have no reason to think the legislature will not act on that suggestion.

Senator BRADLEY. Are there other suggestions that you have that make up that $10 million?

Commissioner WETZLER. No, those are the two that we have recommended. We have not really heard any suggestions from our friends in New Jersey and Connecticut on how we might change the law, other than outright repeal. And the problem with outright repeal is that many features of our law—and I refer in particular to income-splitting work—very beneficially for nonresidents, particularly the two-earner couples about whom the concern seems to be deepest.

Senator BRADLEY. But what you are saying is, you are committed to repeal $10 million worth of the law and that you are looking at other possibilities; is that what you are saying?

Commissioner WETZLER. At the moment we are not considering any specific possibilities because no other cases of unfairness have come to our attention.

Senator BRADLEY. When do you think that those will be repealed?

Commissioner WETZLER. We hope later on this month. The legislature is shooting to get out by June 30th. So if all goes well it would be done by then.

Senator BRADLEY. So that the problem related to the unfairness of taxing pension recipients will be changed and the surcharge will essentially be rebateable to those who have paid it; is that correct?

Commissioner WETZLER. We are proposing to make the pension change retroactive as well on an elective basis so people whose taxes are reduced by that technical correction would have the option of filing amended returns for 1988.

Senator BRADLEY. Okay. One of your objections to the law as such was its retroactivity. That is not a problem, you think, with these two changes?

Commissioner WETZLER. Well, we are making them retroactive on an elective basis. So only people with tax reductions will file amended returns and claim refunds.

Senator BRADLEY. But the argument of retroactivity could also—basically, you can find ways to deal with it as you have found ways to deal with it in these two cases?

Commissioner WETZLER. Well, you could deal with the problem of your Bill's being retroactive by changing the effective date.

Senator BRADLEY. I was only responding to your question.

Now, you say there is a kind of net cut of $180 million for nonresidents. Do you know how that is apportioned by State—New Jersey, Connecticut and other? Could you provide that for the record?

Commissioner WETZLER. I can try. New Jersey, I believe, has done its own analysis and I think the figure they have given us is that about a net cut of around $100-125 million for New Jersey.

Senator BRADLEY. Okay.

Commissioner WETZLER. But I have not seen a breakdown by State.

[The information requested follows:]

STATE-BY-STATE BREAKDOWN OF 1989 TAX CUTS FOR NONRESIDENTS AS A RESULT OF TAX REFORM AND REDUCTION ACT OF 1987

State	Tax cut in millions of dollars	Percent of tax cut
New Jersey	$112	62
Connecticut	31	17
Florida	7	4
Pennsylvania	5	3
California	2	1
Massachusetts	2	1
All other States	22	12
Total	181	100

Note: Apportionment calculation of tax cut was done using historical liability figures for each State. The New Jersey Division of Taxation has made its own estimate of the 1989 tax cut reducing New Jersey commuter's New York tax liability by $125 million. Proposed technical amendments to New York's law would, if passed, make the tax cuts slightly larger.

Senator BRADLEY. And then just so I have a clear idea of how this California method works, are you—is the way the law works—Say I am a violinist and I come to New York and perform a concert for which I am paid $1,000, $500, or whatever. I perform all over the country and my income is like a total of maybe $60,000. You are saying for my performance in New York, for which I am paid $1,000, I will be taxed at a rate as if I had raised $60,000 in New York?

Commissioner WETZLER. You will be taxed on the $1,000, but at the rate that would be applicable, according to the graduated rate schedule, as if your income were $60,000. That is the net effect of the formula.

Senator BRADLEY. $60,000.

Commissioner WETZLER. And I think that is the fair result.

Senator BRADLEY. And the Tax Department has the capability of monitoring all people who come into New York for a performance—a violin performance? How do you do that, just out of curiosity?

Commissioner WETZLER. Well, that is an interesting question because we are making a major effort to try to identify people who owe us tax and who do not file tax returns.

But, first of all, like most other taxing jurisdictions, we rely very heavily on voluntary compliance. However, we try to encourage voluntary compliance by seeking out nonfilers.

Senator BRADLEY. Right.

Commissioner WETZLER. We use a lot of computer matching, and we find various data bases of people who we have reason to think are earning income in New York. The Governor has made a major investment in our computer systems, and we have greatly enhanced our ability to identify nonfilers. We have found a number of lawyers and people in the financial services industries who have not filed. We are proceeding to look at other industries as well.

Senator BRADLEY. Well, I appreciate your testimony very much and I do hope the legislature acts.

Commissioner WETZLER. We are urging them to.

Senator MOYNIHAN. Thank you, Mr. Wetzler.

And now as our concluding witness we have the great pleasure to welcome to the Committee, I believe for the first occasion, Mr. Joseph C. Small, who is counsel to the firm of McCarter & English, attorneys at law, of Newark, New Jersey.

Mr. Small, we welcome you to the Committee. You have a rather extensive prepared testimony which I would like to suggest we put in the record as if read and then you proceed to summarize or expand on as you wish.

STATEMENT OF JOSEPH C. SMALL, ESQUIRE, COUNSEL, McCARTER & ENGLISH, NEWARK, NJ

Mr. SMALL. Thank you, Senator Moynihan, Senator Bradley.

I am here to testify in support of S.800. I think it addresses a very important question of Federalism—not only how should States tax the income of individuals who work in one State and live in another, but how should that decision be made.

I think we have the example before us of one State deciding for itself how that should be done. I know our time is short.

Senator MOYNIHAN. No, sir. We have kept you, now you take your time.

Mr. SMALL. Okay.

Senator MOYNIHAN. Just because you are last does not mean you lose out if others take longer than they ought.

Mr. SMALL. What I was going to indicate to you was that I approach this problem, I think, from a unique perspective and if you will allow me—each of the other witnesses who appeared before you today, you knew not only by their faces but by the positions they held. I have spent some time in the past working a little more quietly and reflecting on these issues.

I was born in New York City and I think I am the only person appearing here today with a good, solid New York accent. I lived there for 28 years. I moved to New Jersey 18 years ago and I have lived and worked in both States. I have commuted in both directions. I have filed resident and nonresident tax returns in both States.

But I think what is more important is that for 4 years I spent a good part of my time fighting the State of New York as a Deputy Attorney General of the State of New Jersey. I defended New Jersey's Emergency Transportation Tax—a tax which you all know was eventually declared unconstitutional. However, similar taxes are now floating around the New Jersey legislature again.

Several years later, as counsel to the New Jersey Director of Taxation, I helped to negotiate with New York the first bi-State sales tax agreement, whereby each State collects money for the other. I can tell you frankly that my efforts defending the Emergency Transportation Tax resulted in substantial transfers, approximating the $50 million a year we are talking about with this tax, going from New York to New Jersey.

My efforts, however, in directing and implementing the sales tax agreement between New York and New Jersey resulted in, to date, $70 million which has been directly collected by the two States and probably an equal or greater amount by increased voluntary compliance. And though the earlier effort might have been more satisfying from a gladiator's point of view, the latter was clearly more rewarding for a public servant interested in good government, good tax policy, good intergovernmental relations and creating the appropriate incentives for citizens to pay their fair taxes fairly and even-handedly administered and fairly apportioned between the States.

I think it is important to note that I think Commissioner Wetzler and Commissioner Bannon, who came here with Governor O'Neill, and Director Baldwin, have a very strong working relationship. But they work within a political context and they are not always free to write the laws of their States as they have the expertise perhaps to do. Laws, as you know, are passed by legislatures and signed by Governors. Sometimes the political problems between the States prevent that good collegial relationship at the Commissioner level from moving up to the legislative and Gubonatorial level.

The whole question of how these taxes are to be determined—the taxes on people who live in one State and work in another—what they should be and how they are determined, I submit to you, is not a matter for judicial, nor is it a matter for Congressional determination. But when the States who have the responsibility for doing this fail to act as they should, I think the only responsible thing for this body to do is to step in and take some action, and to try and get the States to the drawing board.

As part of my work I have seen many examples of States working together. Most importantly, an example which ended up badly but started very well, was back in the late 1950s and early 1960s. New York imposed a very unfair system of personal income tax which permitted itemized deductions of many expenses to New York residents, but not to nonresidents working in New York. There was, as always, a lawsuit; and the lawsuit was lost by an individual who worked in New York and lived in New Jersey.

The whole taxing system was clearly unfair, but the system was constitutional. I think that, perhaps, is the situation we are faced with today. Note that Governor Cuomo and Commissioner Wetzler have told us that they plan to have some of those really egregious provisions of New York's new law carved out. I think the statute probably would withstand constitutional scrutiny. But I do not think it is fair. How do you resolve such an issue when it is not fair?

Well, Governor Rockefeller and Governor Hughes got together and they made an agreement on how income tax should be imposed on individuals who work in one State and live in another; and it involved reciprocal credits and the enactment of the Emergency Transportation Tax. The two Governors got the two legislatures to act, because in those days Governors could get legislators to move.

It was enacted and the peace prevailed for 15 years until numbers changed and times changed and New York decided it wanted out of the deal. And then we entered the protracted like litigation that I participated in.

Similarly, New Jersey had entered into an agreement back in the 1970s with Pennsylvania. New York and New Jersey, New York and Connecticut have sales tax agreements. Now there is a lack of consensus between the two States and I think what we need is a symbol which is familiar to athletes and that is "time out." That is the moratorium.

What is the real problem? We have heard talk about New York having a general overall tax cut. But the commuters are paying a relatively higher tax compared to residents than they did before. And the only reason the tax commuters are paying is because of the overall cut which applies to everybody. I think those of us who have studied the tax system--and Senator Bradley I think you would know this well—what irks people is not the total taxes they pay, but what they pay relative to others.

Prior to the 1986 Act—The normal wage earner was not so upset with the tax system we had and the taxes he paid, what upset him was that high income individuals had a way to shelter their income; the wage earner did not. I think that is precisely what is happening here—the New York worker who lives in Connecticut and New Jersey feels that he should not pay more than the person who works next to him and that if he is to pay more, it should depend on something that happens in New York, not something that happens outside of New York.

I can go on and I think my prepared remarks have enough of what needs to be said.

[The prepared statement of Mr. Small appears in the appendix.]

Senator MOYNIHAN. Mr. Small, it devolves upon me as Chairman to say that at 1:00, under the Rule, we must adjourn the Committee.

Mr. SMALL. Okay. So then why don't I answer any questions you might have. That probably is more useful for me to direct my remarks to what interests you.

Senator MOYNIHAN. Senator Bradley. Would you——

Senator BRADLEY. Thank you, Mr. Chairman.

I would like for you, Joe, if you could, just to tell us what you think might happen if we do not have some kind of resolution.

Mr. SMALL. I think you will have the passage of legislation in New Jersey. Perhaps an emergency transportation tax which the Governor may feel, despite his reluctance, compelled to sign because of New Jersey's shortage of money, and then we could have long litigation. You know, litigation takes forever; the litigation I was involved in which found a tax unconstitutional, found it unconstitutional 7 years after the suit was brought and nobody got a penny back. I attribute that to good lawyering, but some people may say that that is unfair.

I do not think the courts should decide these things. They are political decisions.

Senator BRADLEY. Well, we hope that the wisdom of your views will be seen by the Governor of New York and that he will make some changes in this. We hope that the testimony today amplifies and deepens our own understanding of the problems that the two Governors face, and more importantly, the feelings that are being expressed by countless New Jerseyans and Connecticut residents, and the importance of kind of regional cooperation for all of our mutual benefit.

I think that your own work on this issue is enormously important for me, for the Committee, and I think for all the States concerned. I think your testimony today is illustrative of how much you have thought about it. I thank you very much.

Senator **Moynihan**. If I could just add, I want to agree. That was a very helpful historical reminder of the agreement between Governors Rockefeller and Hughes. Let us, indeed, conclude on the note that Senator Bradley just sounded.

We thank you, Mr. Small, for your very careful testimony. I would finally like to include in the record an article from the Michigan Law Review, by Walter Hellerstein, entitled "Some Reflections on the State Taxation of Nonresident's Personal Income" which I believe is good.

Mr. **Small**. It is a brilliant article.

Senator **Moynihan**. You are familiar with it.

Mr. **Small**. Yes.

Senator **Moynihan**. And thank our Staff, thank our recorder and thank all our witnesses and guests. The hearing is now closed.

[Whereupon, the hearing was adjourned at 1:00 p.m.]

APPENDIX

ALPHABETICAL LISTING AND MATERIAL SUBMITTED

PREPARED STATEMENT OF SENATOR CHRISTOPHER J. DODD

Mr. Chairman, I am here today in an effort to head off an interstate tax war between New York, and Connecticut and New Jersey.

Let me explain briefly what the situation is and how Senator Bradley's legislation, which Senators Lieberman, ~~Lautenberg~~ and I have cosponsored, seeks to end the warfare.

Prior to 1988, the State of New York taxed nonresident commuters on the portion of their income earned in New York *at the tax rate applicable to all people with that amount of income* thus, for example, a Connecticut commuter whose taxable income in New York was $6,000 and whose spouse's taxable income in Connecticut was $28,000 would pay New York taxes on the $6,000 earned in New York at the 3 percent tax rate applicable to *all* people with that amount of taxable income. Thus, under the old law, the Connecticut commuter would pay $180 in taxes.

By contrast, under the New York law that took effect on January 1, 1988, the same Connecticut commuter would still be taxed on $6,000, but would pay the tax rate applicable to a couple with $34,000 of income. That rate is 8.375 percent. Thus, the new law requires a tax of $502.50 on the $6,000 earned in New York, *or nearly three times the old tax.*

Inasmuch as New York law reaches its maximum marginal tax rate at $34,000 of taxable income, frankly the new law will have little effect on wealthy commuters because they are already paying the maximum tax. The people who will be hurt are those with small incomes, for whom an additional $320 can be quite important.

Mr. Chairman, I mentioned earlier that our legislation is designed to head off an interstate tax war. What I mean by that is that since the enactment of the New York law, bills have been introduced in both the Connecticut and New Jersey legislatures that would retaliate against New York commuters who earn income in those States.

I do not quarrel with the notion of a commuter tax. People who use the facilities of another State should pay for those services. However, they should only pay for the services they use, as reflected by the income they earn. To tax out-of-state commuters at a different rate than in-state residents is unfair and bad public policy.

That is why we are introducing this legislation. It is designed to temporarily halt implementation of the New York law while at the same time preventing the implementation of any retaliatory laws adopted by Connecticut or New Jersey. it is our hope that this breathing space—about two and one-half years worth—coupled with the recommendations of a presidentially-appointed commission, will produce an equitable regional solution.

Mr. Chairman, I urge prompt consideration of this important matter of equity in interstate taxation.

PREPARED STATEMENT OF GOVERNOR THOMAS H. KEAN

Good morning. Senator Bradley, Senator Moynihan and Members of the Senate Finance Committee, thank you for the opportunity to testify this morning.

As many of you are aware, the phrase "the war between the states" usually refers to the American Civil War. But lately some have begun to use it to describe the relations between New York and its neighbors, Connecticut and New Jersey.

The most recent unpleasantness between the state involves New York's decision to unfairly—and I believe unwisely—tax out of state residents on the basis of their entire family's income, not on the portion earned in New York.

My constituents are outraged, and I cannot blame them. There is talk of a boycott of New York stores and goods. Our legislature has prepared a series of tax bills that would retaliate, an eye for an eye and a tax for a tax.

It is easy to understand why. New York has enacted a silent tax hike on New Jersey's voters that will cost them $50 million more than they pay now.

This increased taxation was done without any representation. It was done unilaterally, without any hint, without any discussion, without any provocation.

No New Jersey advocate was given the opportunity to oppose this. No New Jersey ever had a chance to vote against it. Two hundred thirteen years. ago we fought a war to end just this sort of treatment.

This tax hike affects real people who have to meet the *real* challenge of paying real bills. Let me tell you about a fellow who lives in New Jersey.

I'm not talking in the abstract here. Let me give you one example, of a man who works as a doorman in New York, and makes about $16,000. His wife is a school administrator back in New Jersey. She makes $42,000.

Instead of being taxed at the rate applicable to $16,000, this fellow is going to have to pay taxes as if he earned $58,000 in New York.

He used to owe New York $521 a year. But thanks to this unfair and unjustifiable tax hike, he's going to pay New York $904—a 74 percent increase. That's a lot of money for a man who makes $16,000 a year.

New York has said that since New Jerseyans use New York services they should pay for them. I agree and they do.

But the New York tax scheme doesn't follow this logic. Instead, it taxes New Jerseyans as if they use those services all of the time, instead of only some of the time.

Let me give you an example: let's say two co-workers, "A" and "B", work side by side at a New York firm and earn the same salary, $30,000.

"A" is single and lives in New York. "B" is married and lives in New Jersey. His wife works in their hometown and also makes $30,000.

"A," who uses New York services 100 percent of the time, will pay New York taxes at a much lower rate than "B", who uses New York's services only 25 percent of the time. The difference is as startling as it is dismaying.

I am pleased to see that New Jersey's Congressional Delegation has been vigilant.

Senator Bradley, Senator Lautenberg and the Members of the New Jersey House Delegation have all written bills to relieve this unjust tax New York would levy. I thank our Delegation Members for moving quickly and thoughtfully.

And I thank our regional neighbors from Connecticut, for joining us to fight this unjust tax. Senators Dodd and Lieberman, and Members of the Connecticut Delegation have been very helpful. (I am pleased that my fellow Governor and good friend Bill O'Neill is here today, too).

These bills share a common purpose to relieve the oppression the New York tax would visit on our friends and neighbors back home.

Senators Bradley and Lautenberg have proposed a bill that represents a step toward reconciliation, not retaliation. It gives us a time to pause and reflect. It prevents similar actions by other states at least for the time being.

We do not seek conflict or confrontation. In fact Senator Bradley's approach thoughtfully seeks to avoid it.

The provision for a moratorium will help cool the ardor for retaliation that has swept my State.

One hundred seventy-three years ago, Chief Justice John Marshall wrote, "The power to tax is the power to destroy." While circumstances are slightly different today, the truth of Marshall's assertion is still valid.

The New York tax represents an attack on regional cooperation and regional prosperity. New York and New Jersey have negotiated a series of agreements in the past decade that have helped both states.

We collect sales tax for each other. We have agreed to use Liberty Island revenues to help the homeless in both states. And we cooperate in identifying tax revenues lost through tax evasion.

These agreements are talismans of cooperation. New York's unilateral tax hike threatens these agreements and that cooperation.

New York and New Jersey and Connecticut hold so much in common.

In an era in which we have seen international competitiveness grow, leaders on both sides of the Hudson realize that the greatest economic rivals we face are across the ocean, not the river.

I was pleased to see that Governor Cuomo has announced plans to scrap the surcharge New York imposed on New Jersey taxpayers.

This is a start, but it is only a start. New York must go further and rewrite this unfair tax.

New York and New Jersey need each other. To impose a patently unfair tax upon New Jersey is to drive a wedge between our states.

Like good neighbors, New York, New Jersey and Connecticut should be able to solve this dispute. But up to this point resolution has proved difficult.

Senator Bradley and his colleagues have suggested a fair and equitable solution. We welcome your assistance.

This is not the first time that the proper relationship between the states has been debated.

Some 200 years ago, a New Yorker wrote, "An unrestrained intercourse between the states themselves will advance the trade of each by an interchange of their respective production, not only for the supply of reciprocal wants at home, but for the exportation to foreign markets.

What Alexander Hamilton argued in Federalist Number 11 is no less true today. The fewer burdens placed on interstate commerce, the better off we'll all be. And no burden is heavier than an unfair tax.

In 1787, Hamilton began publishing the Federalist Papers as a message to the people of New York. Today his message must be heard again. Thank you.

PREPARED STATEMENT OF SENATOR JOSEPH I. LIEBERMAN

Mr. Chairman, I want to thank you and the Finance Committee for holding this hearing on S. 800 and the New York state commuter tax law. I am pleased to be here with Senator Dodd and Connecticut's governor, the Honorable William O'Neill.

The driving force behind this legislation is the issue of fairness. Section 601(e) of the New York State tax code is designed to raise $50 million for New York by taxing non-resident commuters on the basis of income earned outside of New York, as well as income earned in New York. The law is unfair. A Connecticut family, for example, in which one spouse works in New York, would have its New York earnings taxed at a rate based on the family's entire income—including income earned by a spouse working in Connecticut and income from Connecticut investments. This is especially unfair for Connecticut families whose principal sources of income are in Connecticut.

I have no quarrel with New York's attempt to recoup actual costs imposed on the State by Connecticut commuters. But Connecticut residents who do not commute to New York do not contribute to those costs, and their Connecticut income should not be a basis for ratcheting up New York tax rates for Connecticut commuters. Moreover, New York imposes its share of costs on Connecticut too. First of all, many New York residents now commute to Connecticut to work. And pollution from New York is a major contributing factor to some of Connecticut's worst environmental problems, including ozone pollution in the air and pollution in Long Island Sound. The environmental and public health costs of these problems are enormous.

In this climate, the New York commuter tax is a divisive force that drives a wedge between our states at a time when they can least afford it—when regional cooperation on transportation, the environment, and regional economic development is increasingly important.

The bill before this Committee is a measured and moderate response to the commuter tax problem, one that seeks a responsible regional solution. It relieves Connecticut and New Jersey residents of an unfair tax burden, while an independent commission, with representatives from New York, New Jersey, Connecticut and the U.S. Attorney General's office, studies the problems posed by the New York tax law and looks for an effective regional solution. I hope the Committee will act quickly to mark up this legislation and move it through the Senate.

If we in the Congress fail to act, it is not hard to imagine the legislators of Connecticut and New Jersey taking matters into their own hands and enacting retaliatory taxes to penalize New York. As Governor O'Neill can testify, there has been a good deal of pressure on Connecticut to enact a commuter tax provision, and I understand the New Jersey legislature is considering a number of retaliatory tax measures. That kind of tax warfare is not in any State's interest, and it can and should be avoided by passing S. 800.

SUBMITTED BY SENATOR DONALD RIEGLE, JR.

(Excerpts from the Michigan Law Review,
June 1974, Vol. 72, No. 7)

SOME REFLECTIONS ON THE STATE TAXATION OF A NONRESIDENT'S PERSONAL INCOME

*Walter Hellerstein**

I. INTRODUCTION

THE doctrinal ferment that permeated the constitutional law of state taxation in the 1930's[1] evoked an impressive outpouring of scholarly commentary.[2] Detailed consideration was given to questions of situs, domicile, and jurisdiction to tax;[3] to distinctions between subject, rate, and measure;[4] and to the nature of tangibles, intangibles, and income.[5] Judicial opinions were dissected,[6] legal fictions were discredited,[7] and ameliorative proposals, theoretical and practical, were advanced.[8] The Supreme Court signaled the end to much of this conceptual unrest and commentary by resolving many of the issues in definitive,[9] if somewhat inequitable,[10] terms. With the governing principles more or less established, at least to the satisfaction of those who might be motivated to write about them, the business of interpreting and implementing state property, death, and personal income taxes was left largely to the state courts and the state legislatures.[11]

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[1] *Compare* Farmers Loan & Trust Co. v. Minnesota, 280 U.S. 204 (1930), *and* First Natl. Bank v. Maine, 284 U.S. 312 (1932) (due process clause forbids "double taxation" of intangibles) *with* Graves v. Elliott, 307 U.S. 383 (1939), *and* Curry v. McCanless, 307 U.S. 357 (1939) (due process clause no bar to "double taxation" of intangibles). *See also* Pearson v. McGraw, 308 U.S. 313 (1939); Guaranty Trust Co. v. Virginia, 305 U.S. 19 (1938); First Bank Stock Corp. v. Minnesota, 301 U.S. 234 (1937); New York *ex rel.* Cohn v. Graves, 300 U.S. 308 (1937); Wheeling Steel Corp. v. Fox, 298 U.S. 193 (1936); Senior v. Braden, 295 U.S. 422 (1935); Virginia v. Imperial Coal Sales Co., 293 U.S. 15 (1934); Lawrence v. State Tax Commn., 286 U.S. 276 (1932).

[2] *See, e.g.*, the articles cited in notes 3-8 *infra*.

[3] *See* Merrill, *Jurisdiction To Tax—Another Word*, 44 YALE L.J. 582 (1935); Tweed & Sargent, *Death and Taxes Are Certain—But What of Domicile*, 53 HARV. L. REV. 68 (1939).

[4] *See* Lowndes, *Rate and Measure in Jurisdiction To Tax—Aftermath of Maxwell v. Bugbee*, 49 HARV. L. REV. 756 (1936); Rodell, *A Primer on Interstate Taxation*, 44 YALE L.J. 1166 (1935).

[5] *See* Bittker, *The Taxation of Out-of-State Tangible Property*, 56 YALE L.J. 640 (1947); Nossaman, *The Fourteenth Amendment in Its Relation to State Taxation of Intangibles*, 18 CALIF. L. REV. 345 (1930); Rottschaefer, *State Jurisdiction of Income for Tax Purposes*, 44 HARV. L. REV. 1075 (1931).

[6] *See* Lowndes, *The Tax Decisions of the Supreme Court, 1938 Term*, 88 U. PA. L. REV. 1 (1939); Traynor, *State Taxation and the Supreme Court, 1938 Term*, 28 CALIF. L. REV. 1 (1939).

[7] *See* Guterman, *Revitalization of Multiple State Death Taxation*, 42 COLUM. L. REV. 1249 (1942); Lowndes, *Spurious Conceptions of the Constitutional Law of Taxation*, 47 HARV. L. REV. 628 (1934).

[8] *See* Farage, *Multiple Domicils and Multiple Inheritance Taxes—A Possible Solution*, 9 GEO. WASH. L. REV. 375 (1941); Hellerstein & Hennefeld, *State Taxation in a National Economy*, 54 HARV. L. REV. 949 (1941).

[9] *See* Curry v. McCanless, 307 U.S. 357 (1939) (due process clause no bar to "double" death taxation of intangibles); Guaranty Trust Co. v. Virginia, 305 U.S. 19 (1938) (due

With respect to the taxation of personal income, it was plain by 1940 that states were constitutionally free to tax residents on all personal income wherever earned[12] and nonresidents on personal income earned within the state,[13] even though these two principles, taken together, meant that an individual's income might be subject to "double-taxation" by different states.[14] The Court, after toying with the idea for a decade,[15] finally rejected the invitation to forge the due process clause into a tool for preventing multiple taxation[16] and reverted to the ruling law of an earlier era[17] that left the solution of such problems to the collective wisdom of the states.

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process clause no bar to "double" income taxation); Frick v. Pennsylvania, 268 U.S. 473 (1925); Union Refrigerator Transit Co. v. Kentucky, 199 U.S. 194 (1905) (real property and tangible personalty taxable under death and property tax laws only by states in which located).

[10] The Court itself had reservations concerning the impact of its decisions permitting multiple state taxation of the same income or intangibles. "If we enjoyed the freedom of the framers it is possible that we might, in the light of experience, devise a more equitable system of taxation than that which they gave us." Curry v. McCanless, 307 U.S. 357, 373 (1939).

[11] The same cannot be said with reference to state taxation of businesses, where cases continued to be bitterly fought for the next three decades over due process and commerce clause restrictions on state income, sales, and use taxes. *See generally* J. HELLERSTEIN, STATE AND LOCAL TAXATION pts. 4 & 5 (3d ed. 1969); *Developments in the Law—Federal Limitations on State Taxation of Interstate Business*, 75 HARV. L. REV. 953 (1962).

[12] New York *ex rel.* Cohn v. Graves, 300 U.S. 308 (1937); Lawrence v. State Tax Commn., 286 U.S. 276 (1932); Maguire v. Trefry, 253 U.S. 12 (1920).

[13] Travis v. Yale & Towne Mfg. Co., 252 U.S. 60 (1920); Shaffer v. Carter, 252 U.S. 37 (1920).

Throughout this article, the term "resident" is used broadly to include the various concepts associated with the definition of a resident for state tax purposes, such as domicile, presence in the state for other than a temporary purpose or for a specified period of time, and maintenance of a permanent place of abode in the state. *See* G. ALTMAN & F. KEESLING, ALLOCATION OF INCOME IN STATE TAXATION 43 (2d ed. 1950); the term "nonresident" is used to mean an individual other than a resident. In any particular case, of course, the precise meaning of the terms "resident" and "nonresident" depends on the definition set out in a state's tax statute. *See* Note, *Multistate Taxation of Personal Income*, 111 U. PA. L. REV. 974, 975-79 (1963).

[14] Guaranty Trust Co. v. Virginia, 305 U.S. 19 (1938); Hughes v. Wisconsin Tax Commn., 227 Wis. 274, 278 N.W. 403, *appeal dismissed*, 304 U.S. 548 (1938).

[15] *See* cases cited in note 1 *supra*.

[16] *See* Guaranty Trust Co. v. Virginia, 305 U.S. 19, 23 (1938); Curry v. McCanless, 307 U.S. 357, 372-74 (1937).

[17] *See, e.g.*, Bullen v. Wisconsin, 240 U.S. 625 (1916); Blackstone v. Miller, 188 U.S. 189 (1903).

As their need for revenue increased, a growing number of states turned to or relied more heavily upon the personal income tax as a revenue source.[18] To the extent that the states' power to tax personal income was not limited by any constitutional proscription against multiple taxation, fairness to the individual taxpayer depended on the states' self-restraint—or enlightened self-interest[19]—in refraining from exercising their taxing powers to constitutional limits[20] or in granting credits for taxes paid to other states.[21] Despite the absence of any formal interstate agreement designed to achieve greater uniformity and equity in the multistate taxation of personal income,[22] the burden on the individual whose income is taxable by more than one state has been reduced over the years.[23] Nevertheless, the tax status of the multistate taxpayer today is often characterized by uncertainty, unfairness, and considerable confusion.[24]

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[18] While a number of states enacted income taxes during the nineteenth century, *see* J. HELLERSTEIN, *supra* note 11, at 59, they were generally abandoned due to administrative difficulties. *See* Rottschaefer, *supra* note 5, at 1075. The "modern revival" of the income tax began with the adoption of the Wisconsin income tax in 1911. *Id.* at 1075. Today between forty and forty-five states impose personal income taxes—the precise figure depends on whether one includes those states that impose their levy on only a limited category of income or taxpayers. *See* authorities cited in notes 120-26 *infra*, and accompanying text. Over the years, the states have generally raised the rates of their personal income taxes. *Compare, e.g.*, U.S. BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES, STATE INDIVIDUAL INCOME TAXES: 1972, at 429 (1973) *with* U.S. BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES, STATE INDIVIDUAL INCOME TAXES: 1962, at 430 (1963).

[19] *See* Starr, *Reciprocal and Retaliatory Legislation in the American States*, 21 MINN. L. REV. 371 (1937).

[20] *See* IOWA CODE ANN. § 422.8(2) (Supp. 1973); MINN. STAT. ANN. § 290.081 (Supp. 1974); WIS. STAT. ANN. § 71.03(2)(c) (1969) (all excluding nonresident personal service income from taxation if state of residence offers reciprocal exclusion).

[21] *E.g.*, CAL. REV. & TAX CODE § 18001 (1970); N.Y. TAX LAW § 620 (1966); VA. CODE ANN. § 58-151.015 (Supp. 1973).

[22] There is such an agreement with respect to the multistate taxation of business income. Over thirty-five states are members or associate members of the Multistate Tax Compact. P-H STATE AND LOCAL TAXES (All States Unit) ¶¶ 5150-51 (1971). Article III of the Compact gives the multistate taxpayer the option to apportion and allocate his income with reference to state law or with reference to Article IV of the Multistate Compact, reproduced in *id.*, ¶¶ 6310-68, which adopts practically verbatim the Uniform Division of Income for Tax Purposes Act, a proposal worked out by state tax administrators, lawyers, and accountants, aimed at achieving greater uniformity in state taxation of interstate commerce.

[23] Note, *supra* note 13, at 993.

[24] Although an individual's state tax problems do not usually make headlines, there was a notable recent exception: "The official says Mr. Nixon has considered himself a California resident throughout his presidency. . . . However, Mr. Nixon's principal attorney in the White House negotiations with the [California] Franchise Tax Board says that he still takes the position that the President is not a resident 'for income tax purposes.'" Washington Post, Jan. 12, 1974, at 1, col. 3. The Franchise Tax Board agreed with Nixon's contention, ruling that he and Mrs. Nixon were not California residents for state income tax purposes. N.Y. Times, Feb. 2, 1974, at 12, col. 3 (late city ed.). The decision, however, "drew an immediate dissent" from a member

It is within this framework that an intriguing and troublesome issue involving state taxation of personal income has recently arisen Ironically, it grew out of an effort by one state, Vermont, to introduce what in its view was probably a greater degree of "equality" than had previously existed between its resident and nonresident taxpayers. What Vermont did, in effect, was this: In determining the *rate* at which a resident or nonresident taxpayer would pay tax on his Vermont income, the taxpayer's "ability to pay," on which Vermont's progressive rates were predicated,[25] was reckoned by looking to all of his income wherever earned.[26] The result, in principle at least, was to tax resident and nonresident taxpayers with the same federal taxable income at the same rate on their income taxable by Vermont. On its face, this does not seem unfair. From a constitutional perspective, it hardly presents a problem with respect to the Vermont resident because Vermont indisputably possesses the right to tax such income[27] and a fortiori has the right to use it to determine the tax rate. With respect to the nonresident, however, the question is more complex. While it is clear that Vermont may properly insist that the nonresident pay tax on his Vermont-earned income,[28] it is just as clear that Vermont has no jurisdiction to tax the nonresident's non-Vermont income.[29] This raises the question whether taking such nontaxable income into account in determining the rate at which the nonresident's taxable Vermont income will be assessed achieves indirectly what may not constitutionally be achieved directly.

Perhaps it does. Over fifty years ago, however, the Supreme Court

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of the California State Board of Equalization, another tax agency. *Id.* Moreover, the ruling left open the question whether any of Nixon's income that may have been derived from California was taxable by the state. *Id.* The Franchise Tax Board subsequently ruled that Nixon had incurred California tax liability for income earned in California. Washington Post, April 13, 1974, at 1, col. 8.

[25] Indeed, the Vermont legislature has made this explicit: "It is intended that, for any taxable year, individuals, estates and trusts shall be taxed upon only their Vermont income for that year, but that the rate at which the Vermont income of any taxpayer is taxed under this chapter shall reflect the taxpayer's ability to pay as measured by his adjusted gross income for the taxable year." VT. STAT. ANN. tit. 32, § 5820(b) (1970).

[26] VT. STAT. ANN. tit. 32, § 5822 (1970).

[27] *See* cases cited in note 12 *supra*.

[28] *See* cases cited in note 13 *supra*; Nonresident Taxpayers Assn. v. Philadelphia, 341 F. Supp. 1139 (D.N.J. 1971), *affd. mem.*, 406 U.S. 951 (1972).

[29] State v. Burnett, 200 Ark. 655, 140 S.W.2d 673 (1940); People *ex rel.* Monjo v. State Tax Commn., 218 App. Div. 1, 217 N.Y.S. 669 (1926); Greene v. Wisconsin Tax Commn., 221 Wis. 531, 266 N.W. 270 (1936). The paucity of direct authority for this proposition no doubt arises from the fact that states have generally confined the taxation of nonresidents' income to that from local sources. Rottschaefer, *supra* note 5, at 1080.

decided in *Maxwell v. Bugbee*[30] that such a method for establishing the rate of a death tax suffered from no constitutional infirmity, despite Justice Holmes's dissenting observation for himself and three others that "when property outside the State is taken into account for the purpose of increasing the tax upon property within it, the property outside is taxed in effect, no matter what form of words may be used."[31] While a number of states have taken advantage of *Maxwell* to employ a comparable formula for establishing the rate of a nonresident's estate or inheritance taxes,[32] only three states other than Vermont[33] have done so with respect to the taxation of a nonresident's income. Perhaps the reluctance stems from a prevailing sentiment in state legislatures that there is something inequitable about such an exaction;[34] perhaps from neglect; perhaps from some other cause.[35] In any case, Vermont's personal income tax statute raises in a contemporary context some of the fascinating and disturbing problems with which courts and commentators struggled in the 1930's and provides a useful vehicle for examining the scope of state taxing power over a nonresident's personal income.

My purpose here is fourfold: first, to inquire into the theoretical and constitutional underpinning of Vermont's taxing scheme against the background of the case that challenged the validity of the levy; second, to analyze the impact of related legislation on the principles upon which the basic Vermont formula was constructed; third, to determine whether there are reasons of law or policy why other states should not adopt schemes similar to Vermont's; and, fourth, to consider in light of the foregoing some of the recurring problems concerning the treatment of nonresidents under state income tax statutes.

II. THE VERMONT SCHEME—I

Wilfred Wheeler made his home in Enfield, New Hampshire.[36] He was employed as a salesman by Ward Foods, Inc., of White River

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[30] 250 U.S. 525 (1919).

[31] 250 U.S. at 544. The Supreme Court reaffirmed the vitality of the principle in Great Atl. & Pac. Tea Co. v. Grosjean, 301 U.S. 412 (1937).

[32] *See* note 137 *infra* and accompanying text.

[33] Mo. Rev. Stat. Ann. § 143.041 (Supp. 1974); Neb. Rev. Stat. § 77-2715(1) (Supp. 1973); R.I. Gen. Laws Ann. § 44-30-33 (Supp. 1972). *See* note 133 *infra* for a discussion of the former practice of territorial Alaska.

[34] A number of years ago Professor Lowndes stated that "[i]t is difficult . . . to imagine anything more iniquitously unfair than the application of the *Maxwell* formula to income taxation in the present state of the decisions on state jurisdiction to tax income." Lowndes, *supra* note 4, at 770.

[35] *See* Part IV *infra*.

[36] Wheeler v. State, 127 Vt. 361, 249 A.2d 887, *appeal dismissed*, 396 U.S. 4 (1969).

Junction, Vermont, fifteen miles from Enfield. In soliciting orders for Ward Foods from retail food outlets Wheeler made frequent journeys across the Connecticut River, earning a substantial proportion of his sales commissions from sales to Vermont customers; in 1966, one quarter of his earnings, which consisted entirely of sales commissions, represented compensation earned in Vermont. By 1968, the proportion of Wheeler's earnings attributable to his Vermont activities had risen to thirty per cent.[37]

By joining the growing ranks of states that have adopted a federally based state income tax,[38] Vermont made it relatively easy for a nonresident like Wheeler to determine his Vermont income tax liability. The basic taxing provision reads:

> A tax is imposed for each calendar year or fiscal year ending during that calendar year upon the Vermont income earned or received in that taxable year by every individual, estate and trust. The amount of this tax shall be measured by 25 per cent of the federal income tax liability of the taxpayer for the taxable year, reduced by a percentage equal to the percentage of the taxpayer's adjusted gross income for the taxable year which is not Vermont income.[39]

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[37] Wheeler v. State, 127 Vt. 499, 253 A.2d 136, *appeal dismissed*, 396 U.S. 4 (1969). The basic constitutional issue raised by the two *Wheeler* cases was identical. 127 Vt. at 501, 253 A.2d at 138. The principal difference between the two cases was the tax year involved: The first decision concerned 1966, 127 Vt. 361, 249 A.2d 887, while the second concerned 1968. 127 Vt. 499, 253 A.2d 136. In the interim, however, Vermont had amended its income tax law, substituting a federally based income tax employing the federal progressive rates for the progressive Vermont schedule previously employed. VT. STAT. ANN. tit. 32, §§ 5812-14, 5816-21, 5824-25, 5828, 5831-32, 5834-43, 5845-61, 5863-71, 5873-80, 5882-83, 5887, 5889-94 (1970), 5811, 5815, 5822-23, 5828a-30, 5833, 5844, 5862, 5872, 5881, 5884-86, 5888, 5895 (Supp. 1973). The second suit, which was apparently foredoomed from the outset, may well have been brought in anticipation of an appeal to the United States Supreme Court. Had Wheeler challenged only the statute at issue in the initial Vermont decision, the Supreme Court might have dismissed the appeal without reaching the merits in light of the change in the Vermont law. As it turned out, of course, Wheeler gained little by his persistence. For present purposes there is no analytically relevant distinction between the two *Wheeler* cases. Therefore, in examining the issues there presented, references to the reasoning of both will be made interchangeably. However, in order to simplify the discussion, all subsequent references to the Vermont taxing provisions will be to the statutory scheme at issue in the second *Wheeler* decision, which is substantially the same as that in force today.

[38] *See* P-H STATE AND LOCAL TAXES (All States Unit) ¶ 1002 (1974). The extent of federalization will vary from state to state. *Id.*

[39] VT. STAT. ANN. tit. 32, § 5822 (1970). The "Vermont income" of a nonresident taxpayer consists of (1) rents and royalties derived from Vermont property, (2) gains from the sale or exchange of Vermont property, (3) wages, salaries, commissions or other income resulting from services performed in Vermont, and (4) income derived from a business, trade, occupation, or profession to the extent carried on in Vermont. VT. STAT. ANN. tit. 32, § 5823(b) (Supp. 1973). Military pay for full-time active duty with the armed services and income exempted from state taxation under federal law are specifically excluded from the statutory definition of a nonresident's Vermont income. VT. STAT. ANN. tit. 32, § 5823(b) (Supp. 1973). "Adjusted gross income" is defined as "adjusted gross income . . . determined under the laws of the United States." VT. STAT. ANN. tit. 32, § 5811(1) (1970).

Wheeler's total 1968 earnings of $9,219 produced a federal income tax bill of $1,413.33. Twenty-five per cent of this liability amounted to $353.33, and, reducing this figure by the percentage of his adjusted gross income that did not constitute Vermont income—seventy per cent—Wheeler would have owed a sum of $106 to the Vermont tax authorities.

Although the statute unambiguously required a nonresident to compute his Vermont income tax liability pursuant to the method described above, Wheeler took a different approach. He began by ascertaining the portion of his income earned from his Vermont sales activities, which Vermont could unquestionably tax. This he determined to be $2,765.59. After allowing for the statutory deductions and exemptions in the proportion that his Vermont-derived income bore to his total income,[40] Wheeler arrived at a figure of $2,059, which he denominated his "taxable Vermont income." Finally, turning to the Vermont taxing formula quoted above,[41] Wheeler applied the appropriate federal tax rate to his "taxable Vermont income" to produce a figure of $319 and multiplied this by twenty-five per cent to ascertain a Vermont tax liability of $79.75.[42]

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[40] Wheeler's Vermont-derived earnings of $2,765.59 constituted 30 per cent (less $.11) of his total earnings of $9,219. He therefore concluded that he was entitled to 30 per cent of the deductions and exemptions allowed by the Vermont tax statute. Since, as noted above, the Vermont statute was simply derivative of the federal statute, Wheeler determined that he should be permitted to take 30 per cent of the 10 per cent standard deduction, INT. REV. CODE OF 1954, ch. 1, § 141, 78 Stat. 23 (now INT. REV. CODE OF 1954, § 141), and of the $600 personal exemption (of which he was entitled to two). INT. REV. CODE OF 1954, ch. 1, § 151, 68A Stat. 42 (now INT. REV. CODE OF 1954, § 151).

Although the theory behind Wheeler's calculations is clear enough, the computations themselves are erroneous. The arithmetic, as set out by the court, 127 Vt. at 501, 253 A.2d at 138, shows the following:

Appellant's Vermont-Derived Income:	$2,766
30% of deductions: ($921)	307
30% of exemptions: ($1,200)	400
Taxable Vermont Income:	$2,059

Apparently the distinction between one third and 30 per cent escaped Wheeler, who concluded that 30 per cent of $921 equals $307 and that 30 per cent of $1,200 equals $400; in fact, the respective dollar figures should have been $276.30 and $360.

[41] *See* text accompanying note 39 *supra*.

[42] The points of agreement and disagreement between Wheeler and Vermont may be more clearly illustrated in the following manner:

Statutory Computation		Wheeler's Computation	
Total income:	$9,219.00	Total income:	$9,219.00
Vt. income:	2,765.59	Vt. income:	2,765.59
Fed. tax liability on taxable fed. income:	1,413.33	Fed. tax liability on taxable Vt. income:	319.00
Vt. measure of tax (25%):	353.33	Vt. measure of tax (25%):	$79.75
Reduction to reflect percentage of Vt. derived-income:	30%		—
Vt. tax:	$106.00	Vt. tax:	$79.75

The basic issue that divided Wheeler and Vermont was thus clearly drawn: whether it is constitutionally permissible for a state to predicate the progressive rate at which a nonresident pays state income tax upon the nonresident's total income wherever earned.[43] The different answers Wheeler and Vermont offered to this question did not stem from any disagreement over fundamentals. Neither sought to challenge the settled constitutional canons that states may tax nonresidents only on income earned within the state[44] and that they must tax residents and nonresidents on a nondiscriminatory basis.[45] The debate instead centered on whether Wheeler's out-of-state income was in fact being taxed, in violation of the due process clause, and whether Wheeler was a victim of discriminatory treatment by the Vermont tax authorities, in violation of the privileges and immunities[46] and equal protection clauses. The due process question was clearly the crucial one: Any claim of unconstitutional discrimination ultimately rested on the premise that a state could look only to in-state income in classifying nonresidents for rate purposes; hence, were it determined that a state was constitutionally uninhibited by *jurisdictional* principles from looking to nonresidents' extraterritorial income for rate purposes, any argument that the legislature lacked the discretion to consider such income in classifying nonresidents for rate purposes would be drained of force.[47]

It was accepted that the due process issue was one of extraterritoriality. Wheeler sought to demonstrate the extraterritorial nature of the levy by stressing that his Vermont tax bill was increased as a result of his non-Vermont earnings.[48] This, he believed, inexorably led to the conclusion that Vermont was taxing his non-Vermont income in violation of the due process clause. Vermont, on the other hand, without suggesting that it had any right to tax a nonresident's non-Vermont income, rested its case on the fact that the rate, however determined, was applied only to Vermont-derived income.[49]

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[43] In the view of the parties, the issue was "Does the Constitution of the United States bar a State from imposing an effective graduated income tax on nonresidents which for the purpose of applying the effective graduated rates to which residents are subject takes into account the nonresident's total net income from all sources, and then reduces the tax by the ratio of in-state income to total income?" 127 Vt. at 501, 253 A.2d at 138.

[44] Shaffer v. Carter, 252 U.S. 37, 52-54 (1920).

[45] Travis v. Yale & Towne Mfg. Co., 252 U.S. 60 (1920).

[46] U.S. CONST. art. IV, § 2.

[47] *See* note 79 *infra*.

[48] 127 Vt. at 364, 249 A.2d at 889. This was true, of course, only to the extent that Wheeler's non-Vermont income placed him in a higher tax bracket than that in which he would have been if his Vermont income alone were considered.

[49] The Vermont statute required the nonresident to determine his Vermont tax

Confronted with two characterizations of the Vermont levy that were entirely consistent with one another except for the legal conclusion to which they led, the Vermont supreme court, without seriously analyzing the problem, simply adopted the latter characterization and announced: "[I]n reality what is happening is that Vermont income is being taxed at an increased rate and nothing more."[50] The court's position was tenable in so far as it described a constitutionally permissible result: Both *Maxwell v. Bugbee*[51] and *Great Atlantic & Pacific Tea Co. v. Grosjean*[52] had dismissed due process objections to the inclusion of nontaxable extraterritorial elements in the determination of the rate of a tax upon a subject within the taxing power of the state.[53] And, in fairness to the court,

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liability as if he were a resident and then to reduce this to a percentage reflecting that portion of his total income earned in Vermont. In his calculations, the nonresident thus would never actually apply the federal rate schedule to his Vermont-derived income. However, as the following illustration demonstrates, the result would be the same if he *had* directly applied the federal rate schedule to his Vermont-derived income at effective rates reflecting his total income:

Taxpayer *A*		Taxpayer *B*	
(Vermont computation—indirect application of effective federal rates to Vermont-derived income)		(Hypothetical computation—direct application of effective federal rates to Vermont-derived income)	
Total fed. income:	$10,000	Total fed. income:	$10,000
Vt. income:	2,000	Vt. income:	2,000
Fed. tax liability on fed. income:	1,000	Fed. tax liability on fed. income:	1,000
Effective fed. tax rate on fed. income:	10%	Effective fed. tax rate on fed. income;	10%
Vt. measure of tax (25%):	250	—	—
Reduction to reflect percentage of Vt.-derived income (20%):	50	Direct application of effective fed. rate to Vt.-derived income (10%):	200
—	—	Vt. measure of tax (25%):	50
Total Tax:	$ 50		$ 50

[50] 127 Vt. at 364, 249 A.2d at 890.

[51] 250 U.S. 525 (1919).

[52] 301 U.S. 412 (1937).

[53] The due process contentions in both *Maxwell* and *Grosjean* were disposed of mechanically on the grounds that the "privilege" (to succeed to property or to operate chain stores) upon which the levies in question were imposed lay within the taxing power of the state, and that the extraterritorial rate or measure of the tax did not render the exactions constitutionally improper. 250 U.S. at 539-40; 301 U.S. at 424-25. *See* notes 54-55 *infra*. Despite the dubious logic of *Maxwell*, 250 U.S. at 543-44 (Holmes, J., dissenting), a decision the Court itself later described as "on the border line," Frick v. Pennsylvania, 268 U.S. 473, 495 (1925), and notwithstanding the fact that *Grosjean* may be viewed as a case primarily involving the states' police power to regulate the growth of chain stores, 301 U.S. at 425-27; Comment, *Constitutionality of State Chain Store Tax Based on Total Number of Stores*, 44 YALE L.J. 619, 637-38 (1935), the authority of *Maxwell* and *Grosjean* on the issue here under consideration has not been questioned. Alaska S.S. Co. v. Mullaney, 180 F.2d 805, 822-23 n.23 (9th Cir. 1950); Rigby v. Clayton, 2 N.C. App. 57, 162 S.E.2d 682 (Ct. App.), *affd.*, 274 N.C. 465, 164 S.E.2d 7 (1968).

the grounds on which Wheeler and Vermont chose to do battle lay well within the accepted framework for examining due process attacks on state taxes. Nevertheless, the rhetoric of their debate, which the court's opinion perpetuated, failed to come to grips with the critical issue. By asking only whether in-state or out-of-state income was being taxed, neither the parties nor the court ever addressed the basic question whether the fundamental considerations underlying the limitations on a state's jurisdiction to tax a nonresident's income should be translated into corresponding limitations on a state's tax rate structure. Moreover, if one is to look beyond the distinctions between subject, measure, and rate,[54] which, despite their constitutional significance,[55] tend to confine analysis within artificial parameters,[56] one must inquire on broader principles whether the overall taxpaying "ability" of the nonresident is a legitimate concern of the taxing jurisdiction in determining the individual's income tax bill.

We start with the notion, embodied in the concept of due process, that there is a distinction between the relationships of a resident and of a nonresident to the taxing power of a state. The distinction is rooted in the idea that the person who makes his home in a particular state both enjoys the general rights and owes the general obligations of citizenship in that jurisdiction,[57] whereas the nonresident, who enters the state for a more limited purpose or for a shorter period of time, has a more narrowly defined relationship with that jurisdiction.[58] This underlying difference finds concrete expression in Supreme Court decisions reading the due process clause as permitting states to tax the entire income of their residents regardless of its source,[59] while forbidding them to tax nonresidents on income derived from sources outside the state.[60]

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[54] The subject is the legal incidence of a tax. It is the thing or event upon which the power to tax is based; the measure of a tax is the yardstick to which the rate is applied. Subject and measure may be distinct, as in a privilege tax where the subject is the privilege and the measure is, for example, income; or subject and measure may coincide, as in an income tax where the income is both the subject upon which the tax power is predicated and the basis upon which the amount due is calculated.

[55] It is well established that the subject of a tax must lie within a state's taxing power. Whether the measure of a taxable subject must also lie within the state's taxing power depends on the subject of the tax and the nature of the nontaxable value sought to be used as a measure. *Compare* Union Refrigerator Transit Co. v. Kentucky, 199 U.S. 194 (1905) *with* Southern Pac. Co. v. Kentucky, 222 U.S. 63 (1911); *see* Lowndes, *supra* note 7, at 639-43.

[56] *See* Lowndes, *supra* note 7, at 639-43.

[57] Miller Bros. v. Maryland, 347 U.S. 340, 345 (1954); Maguire v. Trefry, 253 U.S. 12, 17 (1920); Fidelity & Columbia Trust Co. v. Louisville, 245 U.S. 54, 58 (1917); Kirtland v. Hotchkiss, 100 U.S. 491, 498-99 (1879).

[58] Shaffer v. Carter, 252 U.S. 37, 52-53 (1902); Goodwin v. State Tax Commn., 286 App. Div. 694, 701, 146 N.Y.S.2d 172, 180 (1955), *affd. mem.*, 1 N.Y.2d 680, 150 N.Y.S.2d 203, 133 N.E.2d 711, *appeal dismissed*, 352 U.S. 805 (1956); Berry v. State Tax Commn., 241 Ore. 580, 583-84, 397 P.2d 780, 782 (1964), *appeal dismissed*, 382 U.S. 16 (1965). Writing in the late seventeenth century, Locke made essentially the same point: "But since the government has a direct jurisdiction only over the land, and reaches the

But what is the theory of income tax jurisdiction that translates the distinction between resident and nonresident into a comparable distinction in the scope of state taxing power? To the extent that the states' jurisdiction to tax income rests on their "complete dominion over all persons, property, and business transactions within their borders,"[61] it is not clear why the scope of their jurisdiction should be greater with respect to residents than nonresidents, since the existence of such "dominion" does not depend on whether it is a resident or nonresident who carries on an occupation, owns property, or engages in business transactions within the state. For the purpose of identifying the basis for the states' less extensive income tax jurisdiction over nonresidents than residents, it may therefore be more fruitful to examine the question in terms of the other fundamental predicate for state tax jurisdiction—the provision of benefits and protection to the taxpayer, his business, and his property.

The Supreme Court set forth its classic exposition of this principle in *Wisconsin v. J. C. Penney Co.*:[62]

> A state is free to pursue its own fiscal policies, unembarrassed by the Constitution, if by the practical operation of a tax the state has exerted its power in relation to opportunities which it has given, to protection which it has afforded, to benefits which it has conferred by the fact of being an orderly, civilized society.
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> . . . [The] test is whether property was taken without due process of law, or, if paraphrase we must, whether the taxing power exerted by the state bears fiscal relation to protection, opportunities and benefits given by the state. The simple but controlling question is whether the state has given anything for which it can ask return.[63]

The Court's statement reflects the view that a state's tax jurisdiction

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possessor of it (before he has actually incorporated himself in the society), only as he dwells upon, and enjoys that: the obligation any one is under, by virtue of such enjoyment to submit to the government, begins and ends with the enjoyment . . . ." J. Locke, Second Treatise of Government § 121, at 62 (B. Blackwell ed. 1966). Of course, a nonresident's relationship to a taxing jurisdiction need not be based on physical presence; it may, for example, grow out of property he owns there.

[59] *See, e.g.*, Lawrence v. State Tax Commn., 286 U.S. 276 (1932).

[60] *See* note 29 *supra* and accompanying text.

[61] Shaffer v. Carter, 252 U.S. 37, 50 (1920); *see also* James v. Dravo Contracting Co., 302 U.S. 134, 138 (1937); Minnesota v. Karp, 84 Ohio App. 51, 53, 84 N.E.2d 76, 79 (1948).

[62] 311 U.S. 435 (1940).

[63] 311 U.S. at 444.

bears a rough relationship to the benefits it provides the taxpayer, and countless decisions of both the Supreme Court and other tribunals have expressed similar sentiments.[64] It is within this conceptual framework that the distinction between the state's jurisdiction to tax the income of residents and nonresidents becomes intelligible. Once one accepts the premise that there is a correlation between a state's right to tax and the opportunities it has given, the protections it has afforded, and the benefits it has conferred, it is not unreasonable to conclude that the scope of the state's income tax jurisdiction over residents and nonresidents should be different. The justification for allowing the states to tax residents on income earned from all sources is "founded upon the protection afforded to the recipient of the income by the state, in his person, on his right to receive the income, and in his enjoyment of it when received,"[65] as well as his "[e]njoyment of the privileges of residence in the state and the attendant right to invoke the protection of its laws . . . ."[66] By the same token, however, since the nonresident receives neither the protection of the state in the enjoyment of his income nor other benefits of residence,[67] except to the extent that he carries on an occupation, transacts business, or owns property in the state, the benefit rationale confines the state's income tax jurisdiction to "incomes accruing to non-residents from their property or business within the State, or their occupations carried on therein . . . ."[68]

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[64] *See, e.g.*, Ott v. Mississippi Valley Barge Line Co., 336 U.S. 169, 174 (1949); Johnson v. Collector of Revenue, 246 La. 540, 573-74, 165 S.2d 466, 477-78 (1964); Morse v. Johnson, 282 A.2d 597, 600 (Me. 1971). As the Supreme Court has said: "The power of taxation, indispensable to the existence of every civilized government, is exercised upon the assumption of an equivalent rendered to the taxpayer in the protection of his person and property, or in the creation and maintenance of public conveniences in which he shares, such, for instance, as roads, bridges, sidewalks, pavements, and schools for the education of his children. Union Refrigerator Transit Co. v. Kentucky, 199 U.S. 194, 202 (1905). In Kiker v. Philadelphia, 346 Pa. 624, 631-32, 31 A.2d 289, 294 (1943), the Pennsylvania supreme court stated in connection with a challenge by a New Jersey resident to the imposition upon him of Philadelphia's income tax: "It is clear that in classifying persons for taxation an obligation on the part of the taxing power to make available some benefit to them must exist."

[65] Lawrence v. State Tax Commn., 286 U.S. 276, 281 (1932).

[66] New York *ex rel.* Cohn v. Graves, 300 U.S. 308, 313 (1937).

[67] Nonresidents have attempted to quantify the benefits denied them as nonresidents in an effort to demonstrate that state income tax laws are unconstitutional insofar as the state levies taxes without providing benefits equivalent to those enjoyed by residents. For example, in American Commuters Assn. v. Levitt, 279 F. Supp. 40 (S.D.N.Y. 1967), *affd.*, 405 F.2d 1148 (2d Cir. 1969), the plaintiffs unsuccessfully contended that the state and city of New York denied them 75.92 per cent of the benefits provided residents, including availability of welfare, education, and housing benefits, 279 F. Supp. at 44. *See also* Stephan v. State Tax Commr., — Del. —, 245 A.2d 552 (1968), *cert. denied*, 394 U.S. 573 (1969).

[68] Shaffer v. Carter, 252 U.S. 37, 52 (1920). In an attempt to develop a jurisdictional

Whether the jurisdictional relationship between the nonresident taxpayer and the taxing state is conceived in terms of the dominion the state exercises over the nonresident's income-producing activities or the benefit and protection the state provides with respect to those activities, one must conclude that the application of progressive rates to the nonresident on the basis of his income from all sources imports into the taxing state's rate structure factors lying outside the scope of such relationship. However, this conclusion does not end the present inquiry. For, even if it raises some doubts about the defensibility of the results in *Maxwell* and *Grosjean*, other questions remain. For one thing, while paying lip service to the proposition that a state may not tax a nonresident or foreign corporation on income arising from out-of-state activities, the Court, with rare exceptions,[69] has sustained state statutes that tax the net income of a foreign corporation by means of formulas under which a corporation's entire net income, wherever earned, is taken into account and is then apportioned to the state by reference to the ratio of in-state property, payroll, and the like to the total wherever owned, employed, or expended.[70] Such formulas have been sustained even though they may constitute a transparent attempt by a state to maximize its revenues by distorting the income that is fairly attributable to activities carried on within its borders.[71] Also, notwithstanding

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construct consistent with the differing theories underlying the states' power to tax the income of residents and nonresidents, one student of the field has suggested that the personal income tax should be considered a dual tax for jurisdictional purposes—a personal tax levied upon all the income of residents and a tax upon income created within a state's borders regardless of the residence of the recipient. Fisher, *Toward a Theory of Personal Income Tax Jurisdiction*, 33 TAXES 373 (1955). Fisher would substitute for the existing system, which he argues erroneously assumes that the income tax is a "single tax with two bases of jurisdiction," *id.* at 380 (*see* Chestnut Sec. Co. v. Oklahoma Tax Commn., 125 F.2d 571, 575 (10th Cir.), *cert. denied*, 316 U.S. 668 (1942)), a system wherein states would levy two separate taxes—one based on residence and the other on situs. Fisher, *supra*, at 380. While Fisher's proposal is conceptually attractive in terms of his notion of jurisdictional neutrality, the state legislatures have shown no inclination to move in that direction, despite the warning that "if the states do not put their own house in order, somebody else eventually will do it for them." Groves & Fisher, *State Multiple Taxation of Personal Income Re-examined*, 33 TAXES 36, 40 (1955).

[69] *E.g.*, Hans Rees' Sons, Inc. v. North Carolina *ex rel.* Maxwell, 283 U.S. 123 (1931).

[70] Butler Bros. v. McColgan, 315 U.S. 501 (1942); Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113 (1920). In *Butler Bros.* and *Underwood Typewriter* the Court rejected the contention that the due process clause was violated, despite the taxpayer's claim in the former that "the formula taxed extraterritorial values," 315 U.S. at 510, and in the latter that the tax "directly or indirectly . . . is imposed on income arising from business conducted beyond the boundaries of the State." 254 U.S. at 120.

[71] Maxwell v. Kent-Coffey Mfg. Co., 204 N.C. 365, 168 S.E. 397, *affd. mem.*, 291 U.S. 642 (1933), represents an extreme example of this tendency. The Court there sustained a

the continued vitality of the generalization that the contours of the relationship between the taxpayer and the taxing state are shaped by the benefits the latter provides the former,[72] it is well established that the due process clause does not require that the taxpayer's tax liability reflect the benefits he actually receives.[73] Above all, however, is the fact that the whole idea of a progressive rate structure predicated on ability to pay[74] and the question of its proper application

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North Carolina income tax that allocated 99 per cent of a corporation's tax base to a state by means of a single-factor property formula, although the taxpayer sold less than 1 per cent of its products in the state. *See generally* Comment, *State Taxation of Interstate Commerce: Roadway Express, the Diminishing Privilege Tax Immunity, and the Movement Toward Uniformity in Apportionment*, 36 U. CHI. L. REV. 186, 207-18 (1968).

[72] *See, e.g.*, Evansville-Vanderburgh Airport Authority Dist. v. Delta Airlines, Inc., 405 U.S. 707, 712 n.5 (1972); Norfolk & W. R.R. v. Missouri State Tax Commn., 390 U.S. 317, 325 n.5 (1968).

[73] *See, e.g.*, Stephen v. State Tax Commr., — Del. —, 245 A.2d 552 (1968), *cert. denied*, 394 U.S. 573 (1969). In *Stephan*, the taxpayers, nonresidents of Delaware, sought to reduce their Delaware tax liability to 25.2 per cent of the amount otherwise due on the ground that, as nonresidents, they were ineligible to receive certain benefits available to Delaware residents. Claiming that their taxes should be reduced in proportion to their ineligibility for such benefits, they asserted that any other application of the Delaware income tax law with respect to them would be unconstitutional. The Delaware supreme court, after adverting to the statement quoted above (*see* text accompanying note 63 *supra*) from Wisconsin v. J.C. Penney Co., 311 U.S. 435, 444 (1940), upon which plaintiffs had relied, concluded that "[t]he general principles there expressed are unquestionable; but in their application they cannot mean that the Fourteenth Amendment requires such individual tailoring of tax bill to benefits derived . . . ." 245 A.2d at 555. *See also* Carmichael v. Southern Coal & Coke Co., 301 U.S. 495, 521-25 (1937); Southern Pac. Co. v. Kentucky, 222 U.S. 63, 76 (1911); American Commuters Assn. v. Levitt, 405 F.2d 1148, 1152-53 (2d Cir. 1969).

[74] It is important to point out that the phrase "ability to pay" is used here and throughout this article solely to identify the rationale that is most frequently invoked by courts, *see, e.g.*, Knowlton v. Moore, 178 U.S. 41, 109 (1900), commentators, *see, e.g.*, Vickrey, *The Problem of Progression*, 20 FLA. L. REV. 437 (1968), and even legislatures, *see, e.g.*, VT. STAT. ANN. tit. 32, § 5820(b) (1970), to justify a progressive rate structure. Nevertheless, as Blum and Kalven make clear, W. BLUM & H. KALVEN, THE UNEASY CASE FOR PROGRESSIVE TAXATION (1953), while "ability to pay does furnish a slogan with emotive appeal to which almost everyone can subscribe. The difficulty, of course, is that the key phrase is so ambiguous that the slogan lacks any content." *Id.* at 64. This article, however, is concerned not with whether there exists a reasoned defense for the ability principle as the basis for a progressive tax structure or indeed whether there is any firm philosophical underpinning at all for such a rate structure. Rather the focus is the operation of a state's progressive rate structure as applied to nonresidents—whatever its rationale. Thus, the phrase "ability to pay" connotes here simply the generally accepted rationale for progressivity; its use is not designed either to suggest a preference for that rationale over others or to suggest that progressivity is defensible except on purely redistributive grounds.

The term "benefit" is used in the text with reference to the jurisdictional relationship between the taxpayer and the taxing state, whereas Blum and Kalven use the same term to describe one of the theoretical justifications for a progressive tax system. *See id.* at 35-39. As used in this article, the notion of benefit as a basis for taxation is meant only to connote the idea that taxes are thought loosely to represent the prices one pays for the services rendered by government, *cf.* Guterman, *supra* note 7, at 1250-51; Blum and Kalven, by contrast, use the term more specifically with to nonresidents involve issues that lie entirely outside the conceptual universe of dominion and benefit. While the dominion and benefit rationales relate to the jurisdictionally appropriate scope of the relationship between the taxpayer and the state, the rationales for progressivity relate principally to the relationship of some taxpayers to other taxpayers.[75]

The determination that a taxpayer shall shoulder a proportionately greater tax burden as his income rises represents a basic political judgment about the manner in which the costs of government are to be shared. It seeks to distinguish taxpayers with reference to how much they earn and demands increasing portions of their income on the basis of that distinction. This is not a determination that has any necessary relationship to political boundaries. If a state resolves that it is appropriate for an individual who earns $100,000 to pay at the rate of $.25 on the dollar, it would appear to make no difference in terms of that determination whether the individual accumulated the sum by earning $100,000 in one state or $2,000 in fifty states. The argument for permitting a state to look to a taxpayer's total income from all sources for purposes of its progressive rate structure would therefore seem to be a logical corollary of the rationale for such a rate structure, a rationale that has essentially nothing to do with the territorial limits of the taxing state.

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reference to the theory that the benefits one receives from government increase as income increases—and perhaps even more rapidly than income, in which event a progressive tax would be theoretically justified. W. Blum & H. Kalven, *supra*, at 35-39; *see* Magoun v. Illinois Trust & Sav. Bank, 170 U.S. 283, 300 (1898).

[75] One might argue that this contrast oversimplifies the problem. W. Blum & H. Kalven, *supra* note 74, at 58, consider a number of theoretical rationales for progressivity, not all of which can be characterized as involving solely the relationship between one taxpayer and another rather than that between a taxpayer and the taxing jurisdiction. Progressivity has been justified on the grounds that it contributes to the maintenance of a high and stable level of economic activity, *id.* at 29-35; that it allocates the tax burden according to the benefits received from the government, *id.* at 35-39; that it equitably apportions among taxpayers the sacrifice that the payment of a tax entails, *id.* at 39-47; that it produces the minimum aggregate sacrifice (or the greatest good for the greatest number), *id.* at 49-55; that it distributes the tax burden in accordance with ability to pay, *id.* at 64-68; and that it mitigates economic inequality through an effective redistribution of income. *Id.* at 70-80. Nevertheless, it seems fair to say that the most compelling justifications for progressivity, and those most widely perceived to form the basis for it, relate essentially to fairness among taxpayers—that is, how the tax burden is to be shared—rather than to the jurisdictional relationship between taxpayer and taxing jurisdiction. Whether these rationales are couched in terms of "ability to pay," "equal sacrifice," or "income redistribution," they all signify a judgment that the fiscal obligations of the taxpayer depend on his position in relationship to other taxpayers—whether he has the same taxpaying ability as others, whether he is being asked to sacrifice the same as others, whether he should be made economically more equal to others; they do not bear on whether his relationship to the state justifies the exaction.

Since the justification for a progressive rate structure is rooted in fundamentally jurisdictionless concepts regarding the appropriate distribution of the tax burden, one confronts an analytic impasse. If the determination by a taxing state that different taxpayers with different incomes should pay taxes at different rates is a value judgment that does not depend on the source of the taxpayer's income, it makes no sense, at least insofar as that value judgment is concerned, to inquire into the jurisdictional nexus between the taxing state and the taxpayer's income. By a parity of reasoning, if a state's right to tax a nonresident is roughly delimited by the notion of territorial dominion or *quid pro quo*, it is difficult rationally to defend a tax that is determined in part by factors outside the critical jurisdictional relationship.

The clash of concepts is unavoidable[76] and one must face the central question head on: If a state has no business increasing a nonresident's tax bill by taxing income the nonresident earns elsewhere, what business does it have increasing that bill by considering such income in its rate structure? The honest answer seems to be that the outcome is doctrinally impure; the conflict is *not* more apparent than real. There *is* a "logical antagonism"[77] between the principles of dominion and benefit underlying a state's power to tax the income of nonresidents and the principles underlying a progressive tax rate structure predicated on ability to pay. In short, the result in *Wheeler* is an untidy compromise.

Perhaps it is possible to make intellectual peace with the intersection of these conflicting theories of taxation by acknowledging the conflict and learning to live with it. It may be difficult to dismiss a lurking sense of discomfort when one contemplates that it is on the basis of what a New Hampshireman does in New Hampshire that his Vermont tax increases. Perhaps the discomfort stems from the idea that Vermont ought not be permitted to discourage, albeit weakly, a New Hampshireman's income-producing activity in New Hampshire by increasing his Vermont tax bill as a result thereof.[78] In the final analysis, however, the progressive principle proves at least as compelling. We cannot rationally and fairly implement the concept that those who earn more should pay taxes at an increasingly higher rate unless we determine how much an individual earns without regard to the particular political entity or entities in which his earnings are accumulated. In sum, like the case for progression itself, the argument for freeing a progressive rate structure from jurisdictional restraints associated with state taxing power appears to be "stubborn but uneasy."[79]

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[76] This is not to suggest that the two theories of taxation necessarily work at cross-purposes. In Shaffer v. Carter, 252 U.S. 37 (1920), a progressive income tax was levied on a nonresident by the state of Oklahoma. However, only Oklahoma-earned income was considered in determining the nonresident's tax rate. The Court could thus unabashedly speak of "dominion," "benefit," and "ability to pay" in the same breath:

> In our system of government the states have general dominion, and, saving as restricted by particular provisions of the Federal Constitution, complete dominion over all persons, property, and business transactions within their borders; they assume and perform the duty of preserving and protecting all such persons, property, and business, and, in consequence, have the power normally pertaining to governments to resort to all reasonable forms of taxation in order to defray the governmental expenses . . . .
>
> Income taxes are a recognized method of distributing the burdens of government, favored because requiring contributions from those who realize current pecuniary benefits under the protection of the government, and because the tax may be readily proportioned to their ability to pay.

252 U.S. at 50-51. Not until the taxing jurisdiction attempts to look beyond the nonresident's in-state earnings to determine his tax rate does the latent conflict between the principles of dominion or benefit and ability to pay become apparent.

[77] *See* Lowndes, *supra* note 4, at 768.

III. THE VERMONT SCHEME—II

Progressive taxation, however alluring philosophically, may become politically inexpedient at high rate levels. Perhaps for this reason, the Vermont legislature, despite its declaration that the

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[78] Of course, the empirical foundation for such an idea is at best problematic, for it has never been demonstrated that tax disincentives, especially at such low marginal rates as Vermont's statute imposes, discourage income-producing activity. *See* O. ECKSTEIN, PUBLIC FINANCE 73-75 (1964); Break, *Income Taxes and Incentives To Work: An Empirical Study*, 47 AM. ECON. REV. 529 (1957).

[79] W. BLUM & H. KALVEN, *supra* note 74, at 103.

In addition to his due process claims, Wheeler contended that the Vermont levy discriminated against nonresidents in violation of the equal protection clause and article IV's privileges and immunities clause. Once the jurisdictional objections to the consideration of nontaxable income for rate purposes are disposed of, however, any suggestion that a classification based on consideration of such income is unconstitutionally discriminatory borders on the frivolous. An assertion of irrational and arbitrary classification against nonresidents in violation of the equal protection clause has substance only if one characterizes the classification scheme as Wheeler did. He would have compared himself with the class of resident taxpayers all of whose income was earned in Vermont in an amount equal to what he had earned there and concluded that the higher rate at which his Vermont income was being taxed constituted arbitrary and unreasonable discrimination against outsiders. Inasmuch as Vermont was under no constitutional constraint to adopt Wheeler's comparative criteria, and, indeed, for reasons discussed above, could legitimately reject such a comparison in favor of one comparing taxpayers having the same total income wherever earned, the equal protection and privileges and immunities clauses were not violated. *See, e.g.*, Mullaney v. Anderson, 342 U.S. 415 (1952); Wheeling Steel Corp. v. Glander, 337 U.S. 562, 572-74 (1949). *See also* Lucas, *Constitutional Law and Economic Liberty*, 11 J. LAW & ECON. 5, 28-29 (1968).

Vermont income tax was intended to "reflect the taxpayer's ability to pay as measured by his adjusted gross income for the taxable year,"[80] felt constrained to soften the impact of its graduated rate structure. It did so by providing that a taxpayer's "net" Vermont income tax liability[81] should not under any circumstances exceed 4.5 per cent of his "total income."[82] If the computed tax exceeds the statutory ceiling, the taxpayer's bill is reduced by the amount of the excess. While Vermont may thus be accused of abandoning the theoretical basis of its income tax system by undermining its progressive rate structure, in terms of dollars and cents the statutory ceiling offered cold comfort to those who saw in it a relief from the burden of progressivity. The measure did, however, set the stage for a serious constitutional challenge.

By limiting one's "net" Vermont income tax liability to 4.5 per cent of one's "total income," the Vermont legislature engrafted a mechanism for achieving a proportional contribution from its taxpayers upon a system designed to achieve a progressive contribution. A proportional rate structure reflects the belief that individuals contribute their fair share to the costs of government when each pays an equal share of his income to defray those costs. In contrast, a progressive system reflects the belief that it is appropriate for those with greater incomes to pay greater shares of their income to defray such costs. The two theories may peacefully coexist in the same tax system so long as they operate at different rate levels or on different categories of income. In the federal system, for example, the rate structure on ordinary income is progressive up to the rate of seventy per cent, at which point it becomes proportional, and for certain taxpayers the rate on capital gains is entirely proportional.[83]

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[80] VT. STAT. ANN. tit. 32, § 5820(b) (1970).

[81] His estimated Vermont tax liability less the federal tax savings resulting from Vermont taxes paid. VT. STAT. ANN. tit. 32, § 5828(a) (1970).

[82] *Maximum tax liability.*—(a) Notwithstanding any other provision of this chapter to the contrary, the Vermont income tax of an individual for any taxable year shall not in any case equal an amount such that the combined Vermont and federal income tax liability of the taxpayer for that taxable year, less the federal income tax liability (without consideration of the deduction for Vermont income taxes paid or accrued) of the taxpayer for that taxable year exceeds 4 1/2 percent of the total income of the taxpayer for that taxable year.

(b) For purposes of this section, the "total income" of any individual for any taxable year means the sum of:

(1) the adjusted gross income,

(2) any amount of capital gains excluded from adjusted gross income, and

(3) interest on obligations of any state, municipality or the United States,

of the taxpayer for that taxable year.

VT. STAT. ANN. tit. 32, § 5828 (1970).

[83] INT. REV. CODE OF 1954, §§ 1, 1201(b).

The underlying conflict surfaces only when there is an overlapping of rate structures. This is precisely what happens under Vermont's tax scheme, although generally at income levels that make the problem academic for most taxpayers.[84] At the point that a taxpayer's "net" Vermont tax liability[85] reaches 4.5 per cent of his "total income,"[86] his Vermont tax bill begins to increase on a proportional rather than a progressive basis.[87] While the arithmetic involved in determining the precise effect of the statutory ceiling requires a number of separate computations[88] and varies with the particular circumstances of each taxpayer, the basic operation and impact of the formula may be simply illustrated.[89] Its effect on the nonresident taxpayer, however, created a problem that was not academic, and an illustration that was hardly hypothetical.[90]

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[84] Although variations among individual taxpayers with respect to deductions, exemptions, and the like make it impossible to indicate a precise income level at which the Vermont limitation begins to operate, "[i]t is unlikely that the provision will benefit most taxpayers." Instructions to Vermont Form 103A ("Special Tax Limitation Schedule"). Since the ceiling only operates if a taxpayer's *net* Vermont tax liability (which may be substantially less than his actual Vermont tax liability) exceeds 4.5 per cent of his *total* income (which may substantially exceed his taxable income), it is highly improbable that the ceiling would have any impact on taxpayers with less than $25,000 total income. At such an income level, and without any unusual deductions or consideration of the distinction between actual and net Vermont tax liability, a married taxpayer would be paying an effective federal rate of about 19 per cent of his total income for calendar year 1973; and his Vermont tax liability would be 28 per cent of that figure, *see* Vt. Stat. Ann. tit. 32, §§ 5822 (1970), 5830 (Supp. 1973), or 5.3 per cent of his total income.

[85] *See* note 81 *supra*.

[86] His federal adjusted gross income plus certain capital gains and tax-free income. Vt. Stat. Ann. tit. 32, § 5828(b) (1970).

[87] *See* note 89 *infra*.

[88] Vermont Form 103A ("Special Tax Limitation Schedule") must be completed by taxpayers entitled to and desiring to take advantage of the 4.5 per cent limitation. One must make 19 entries and, under some circumstances, more than 10 separate calculations to complete the form.

[89] Assume a Vermont resident with a total 1973 income of $100,000 and taxable income of $76,000. His federal tax liability would amount to $31,020 and his Vermont tax liability, before taking account of the statutory ceiling, to 28 per cent of this figure, or $8,685.60. Vt. Stat. Ann. tit. 32, §§ 5822 (1970), 5830 (Supp. 1973). Assume further that our hypothetical taxpayer took a deduction of $6,000 for taxes paid to Vermont during calendar year 1973. Int. Rev. Code of 1954, § 164. In substance, he must subtract the tax benefit of this deduction at his highest marginal rate, that is, 58 per cent of $6,000 ($3,480), from his Vermont tax liability to determine his *net* Vermont tax liability of $5,205.60 ($8,685.60 less $3,480). Vt. Stat. Ann. tit. 32, § 5820(b) (1970). Then, applying the 4.5 per cent ceiling ($4,500 on a total income of $100,000), the taxpayer determines that his net Vermont tax exceeds the limitation by $705.60, which he may subtract from his Vermont tax of $8,685.60 for a total tax bill of $7,980.

The following table illustrates the operation of Vermont's proportional limitation by a comparison (using 1973 federal and state rates) of the taxpayer described above with another who has earned an additional $1,000 of total and taxable income, all other things being equal:

Like their fellow New Hampshireman Wheeler, Myron and Pearl Landgraf earned a portion of their income in Vermont. Unlike

	Taxpayer *A*	Taxpayer *B*
Total income	$100,000.00	$101,000.00
Taxable income	76,000.00	77,000.00
Federal tax liability	31,020.00	31,600.00
Estimated Vermont tax liability (28% of federal tax liability)	8,685.60	8,848.00
Federal deduction for Vermont tax paid	6,000.00	6,000.00
Federal tax benefit	3,480.00	3,480.00
Net Vermont tax liability	5,205.60	5,368.00
Statutory ceiling (4.5% of total income)	4,500.00	4,545.00
Difference between statutory ceiling and net Vermont tax liability	705.60	823.00
Final Vermont tax	7,980.00	8,025.00
Increase in Vermont tax liability as percentage of increase in total income	—	4.5%

One additional point is relevant. Because the statutory ceiling applies to the *net* Vermont tax liability, one's final Vermont tax bill depends in part on the federal deduction for Vermont taxes paid. As the following table demonstrates, however, even though one's final *Vermont* tax bill will vary depending on the federal deduction for Vermont taxes paid, this will not affect one's *total* tax bill (Vermont plus federal) if the statutory ceiling applies. The table also demonstrates that when the statutory ceiling does not apply (as in the case of taxpayer *A*), the combined state and federal tax bill may be slightly lower than that of a taxpayer in an identical tax situation except for the amount of state taxes paid during the calendar year. The taxpayers in the table differ only in the amount of their federal deduction for Vermont taxes paid, which directly yields differences in their federal taxable income.

	Taxpayer *A*	Taxpayer *B*	Taxpayer *C*	Taxpayer *D*	Taxpayer *E*
Total income	$100,000	$100,000	$100,000	$100,000	$100,000
Fed. deduction for Vt. taxes paid	8,000	7,000	6,000	5,000	0
Taxable income	74,000	75,000	76,000	77,000	82,000
Fed. tax liability	29,970	30,470	31,020	31,600	34,500
Estimated Vt. tax liability (28% of fed. tax liability)	8,391.60	8,531.60	8,685.60	8,848.00	9,660.00
Fed. tax benefit for Vt. deduction	4,530.00	4,030.00	3,480.00	2,900.00	0
Net Vt. tax liability	3,861.60	4,501.60	5,205.60	5,948.00	9,660.00
Statutory ceiling	4,500.00	4,500.00	4,500.00	4,500.00	4,500.00
Difference	0	1.60	705.60	1,448.00	5,160.00
Final Vt. tax	8,391.60	8,530.00	7,980.00	7,400.00	4,500.00
Vt. tax plus fed. tax	8,391.60	8,530.00	7,980.00	7,400.00	4,500.00
	29,970.00	30,470.00	31,020.00	31,600.00	34,500.00
	38,361.60	39,000.00	39,000.00	39,000.00	39,000.00

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[90] Landgraf v. Commissioner, 130 Vt. 589, 298 A.2d 551 (1972).

Wheeler, however, their income was substantial, and thus they faced the problem of how to construe the impact on a nonresident taxpayer of Vermont's 4.5 per cent ceiling. In 1969 the Landgrafs' "total income" was $76,886.52.[91] As a result of various deductions, including one for Vermont income taxes paid, the Landgrafs' federal taxable income amounted to $69,456.85 and their federal tax to $27,312.17. A taxpayer's Vermont tax liability for 1969 (without consideration of the statutory limitation) was 28.75 per cent[92] of his federal tax liability, which for the Landgrafs amounted to $7,852.24. If under these circumstances the Landgrafs had been Vermont rather than New Hampshire residents, the Vermont statutory ceiling would have significantly reduced their Vermont tax liability; inasmuch as their "net" Vermont tax liability[93] exceeded 4.5 per cent of their total income ($3,459.89) by $3,047.75, they would have been entitled to reduce their Vermont tax as originally computed[94] by this amount, to produce a final Vermont tax liability of $4,804.49.

In their view, the Landgrafs could ascertain their Vermont tax liability simply by adjusting the above determined Vermont tax liability to reflect the portion of their total income earned in Vermont. In 1969 their Vermont-derived income was fifty-four per cent of their total income. Hence, they figured their Vermont tax liability to be fifty-four per cent of the Vermont tax liability of a Vermont resident with the same federal taxable income as theirs, and this came to $2,594.42.[95] Indeed, this was precisely the method by which the Vermont tax commissioner determined the New Hampshire resident's Vermont tax liability in *Wheeler*.[96]

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[91] 130 Vt. at 591, 298 A.2d at 553. For purposes of the textual discussion some of the arithmetical operations involved in making the statutory computations are collapsed or simplified and others are omitted if not germane to the analysis. The actual calculations made pursuant to Form 103A, *see* note 88 *supra*, by both the Landgrafs and the Vermont Commissioner of Taxes are set out in 130 Vt. at 592-94, 298 A.2d at 553-54.

[92] As indicated above, *see* text accompanying note 39 *supra*, when Vermont introduced its federalized tax system, a taxpayer's Vermont tax liability was 25 per cent of his federal tax liability. In 1969, however, the Vermont legislature enacted a 15 per cent tax surcharge effective for taxable years beginning after December 31, 1968, which brought the effective Vermont rate to 28.75 per cent of one's federal tax liability. This rate applied to the Landgrafs in the tax year at issue. Vermont subsequently reduced the surcharge so that a taxpayer's effective Vermont tax rate is 28 per cent of his federal tax liability for 1973 and 27.25 per cent for later years. VT. STAT. ANN. tit. 32, § 5830 (Supp. 1973).

[93] $6,507.64, or their Vermont tax liability as originally computed ($7,852.24) less the federal tax savings resulting from their deduction for $2,246.37 Vermont taxes paid ($1,344.60).

[94] 28.75 per cent of the Landgrafs' federal tax liability, or $7,852.24.

[95] 54 per cent of $4,804.49.

[96] 127 Vt. at 363, 249 A.2d at 889; 127 Vt. at 501, 253 A.2d at 138.

Despite the logical basis of the Landgrafs' computations and their consistency with the principles approved in *Wheeler*, the operation of the statutory ceiling with respect to nonresidents compelled a different result. Because the provision stated that a taxpayer's net "Vermont income tax" should not exceed "4½ per cent of the total income of the taxpayer for that taxable year,"[97] it offered taxpayers in the Landgrafs' position no benefit. In calculating the 4.5 per cent ceiling, a nonresident was required to look to his "total income" *wherever earned*; but in determining whether the ceiling limited his Vermont tax bill, the nonresident was required to look to his actual "net" Vermont tax liability, which had been reduced to reflect only income *earned in Vermont*. The Landgrafs were consequently forced first to reduce the Vermont percentage[98] of their federal tax liability by an additional 46 per cent to reflect the ratio of their non-Vermont income to their Vermont income. As a result, the Landgrafs' "net" Vermont tax liability amounted to only $2,895.61,[99] well below the statutory limitation of 4.5 per cent of their total income ($3,459.89). Since the limitation was not exceeded, the Landgrafs were liable for the full Vermont tax—as initially computed and appropriately adjusted to reflect solely their Vermont income—of $4,240.21.

The unequal impact of Vermont's tax ceiling becomes clear when it is evaluated in terms of Vermont's constitutional power to tax the income of residents and nonresidents. In presenting the Landgrafs, only fifty-four per cent of whose total income was earned in and hence taxable by Vermont, a tax bill of $4,240.21 while presenting a hypothetical Vermont resident with the same income, all of which is taxable by Vermont, a tax bill for $4,804.49, Vermont has exacted a substantially larger portion of the nonresident's income than of the resident's income insofar as it may properly tax such income. Indeed, under Vermont's taxing scheme the Landgrafs pay roughly ten cents on every dollar taxable and taxed by Vermont, whereas their imagined counterparts would pay just six cents on every such dollar.[100]

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[97] VT. STAT. ANN. tit. 32, § 5828(a) (1970). The provision is quoted in full at note 82 *supra*.

[98] 28.75 per cent.

[99] Their Vermont tax liability as originally computed ($4,240.21) less the federal tax savings resulting from their deduction for $2,246.37 Vermont taxes paid ($1,344.60).

[100] For the Landgrafs, the figure was calculated by determining the percentage that their final Vermont tax liability ($4,240.21) represented of their Vermont income ($41,518.72, or 54 per cent of their total statutory income of $76,886.52); for their Vermont counterparts, the figure was calculated by determining the percentage that their final Vermont tax liability ($4,804.49) represented of their total statutory income ($76,886.52). While it is arguably unrealistic to assume that a Vermont

There can be no justification for such a disparity—at least in terms of the rationale that underlay Vermont's treatment of nonresidents with respect to her progressive rate structure. The basic proposition that legitimated Vermont's progressive rate structure as applied to nonresidents was that for rate purposes there should be no differentiation between residents and nonresidents who earn the same amount of money—regardless of where earned. The wandering minstrel who earned $2,000 in fifty states would in principle pay to Vermont the same portion of his $2,000 that an equally successful minstrel who never wandered outside Vermont would pay on his $100,000, in contrast to the significantly lower portion (if any) that the nonresident would pay were he taxed as a Vermont resident whose income totaled $2,000. This, of course, is what *Wheeler* was all about. Yet only a few years later, in *Landgraf*, the Vermont supreme court stood the rationale of *Wheeler* on its head by approving a statutory scheme that permitted Vermont to demand proportionally more of the constitutionally taxable income of a nonresident than of a resident.

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and a non-Vermont taxpayer with the same total income would have identical deductions for Vermont taxes paid, as the Landgrafs assumed in comparing themselves with a hypothetical Vermont resident, the basic discrimination against the nonresident remains even if one compares a resident and nonresident whose federal deductions for Vermont taxes paid reflect the portion of their income taxable by Vermont. The following illustration (using 1973 rates) assumes the nonresident has earned 50 per cent of his income in Vermont; it also assumes that the resident and nonresident have equal taxable incomes, since it is on that basis that Vermont purports to treat all taxpayers equally for rate purposes:

	Resident	Nonresident
Total income	$100,000	$100,000
Per cent taxable by Vermont	100%	50%
Fed. deduction for Vt. taxes paid	6,000	3,000
Taxable income	76,000	76,000
Fed. tax liability	31,020	31,020
Estimated Vt. tax liability (28% of fed. tax liab.)	8,685.60	8,685.60
Adjustment for nonresident	—	4,342.80 (50% of 8,685.60)
Fed. tax benefit for Vt. deduction	3,480.00	1,740.00
Net Vt. tax liability		
Statutory ceiling	4,500.00	4,500.00
Difference	705.60	—
Final Vt. tax	7,980.00	4,342.80
Final Vt. tax as percentage of total income taxable by Vermont	7.98%	8.69%

Landgraf was not one of the Vermont supreme court's happiest hours. Apparently lacking any firm analytical basis for upholding the levy, the court relied on bald conclusions:

> Because appellants earn some 46% of their income from sources outside Vermont it is clearly erroneous for the appellants to compare themselves with a Vermont resident having the same federal taxable income as they do for the purpose of determining if the ceiling . . . applies. Appellants have not made the showing of discrimination required by the doctrine set forth in Wheeler v. State . . . because they have not shown themselves to be disadvantaged when compared to another in an equivalent position.[101]

The court never suggested why the Landgrafs' comparison was "clearly erroneous," nor how it had determined the proper basis for comparison. In *Wheeler*, the court had reasoned that it *was* proper to compare residents and nonresidents with the same federal taxable income in determining whether residents and nonresidents were being accorded equal treatment with respect to the rate at which they paid taxes on their income taxable by Vermont.[102] But the *Landgraf* court flatly refused to follow this rationale to its logical conclusion in applying the statutory ceiling. It failed to confront the fact that the statute introduced a bias against nonresidents with respect to the rate burden on income constitutionally taxable by Vermont. Instead it attempted to justify the result with the analytically irrelevant observation that "the New Hampshire taxpayer would never pay any greater tax than his Vermont counterpart."[103]

The constitutional questions raised by the operation of Vermont's statutory ceiling with respect to nonresidents are substantial. Both the privileges and immunities clause of article IV and the equal protection clause generally forbid states to discriminate against outsiders, in favor of locals.[104] Admittedly, neither clause holds the states to an "iron rule of equality"[105] or condemns distinctions based on rational criteria.[106] Yet somewhere the constitutional line must be drawn in a manner that allows the state to exercise its taxing power freely but not so freely that it is allowed to care for its own at the expense of others. According to Justice Frankfurter: "I think it is fair to summarize the decisions which have applied Art. IV, § 2, by saying that they bar a State from penalizing the citizens of other States by subjecting them to heavier taxation merely because they are such citizens or by discriminating against citizens of other States in the pursuit of ordinary livelihoods in competition with local citizens."[107] Essentially the same could be said with respect to the Court's decisions applying the equal protection clause to alleged tax discrimination between residents and nonresidents,[108] although they are phrased in terms of a state's duty to "proceed upon a rational basis and . . . not resort to a classification that is palpably arbitrary."[109]

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[101] 130 Vt. at 595-96, 298 A.2d at 555.

[102] 127 Vt. at 366, 249 A.2d at 891.

[103] 130 Vt. at 597, 298 A.2d at 556.

[104] *See* Mullaney v. Anderson, 342 U.S. 415 (1952); Toomer v. Witsell, 334 U.S. 385 (1948), with respect to the privileges and immunities clause, U.S. CONST. art. IV, § 2; *see* WHYY, Inc. v. Glassboro, 393 U.S. 117 (1968); Wheeling Steel Corp. v. Glander, 337 U.S. 562 (1949), with respect to the equal protection clause. While the privileges and immunities clause speaks of the "citizens" of the states, the Supreme Court has stated that "a general taxing scheme . . . if it discriminates against all non-residents, has the necessary effect of including in the discrimination those who are citizens of other States." Travis v. Yale & Towne Mfg. Co., 252 U.S. 60, 79 (1920). By contrast, however, the recent decision upholding New York's reduced stock transfer tax rate for nonresidents demonstrates that favoring outsiders over locals may not, in certain circumstances, be adjudged violative of either the privileges and immunities clause or the equal protection clause. Boston Stock Exch. v. State Tax Commn., — App. Div. 2d —, 357 N.Y.S.2d 116 (1974).

How does Vermont's taxing scheme stand up against these criteria? One could argue that Vermont's proportional tax ceiling neither singles out nonresidents for discriminatory treatment nor makes any arbitrary classification. The limitation is neutral on its face (4.5 per cent), has universal applicability (all taxpayers), and employs uniform standards (net Vermont tax liability and total income from all sources). Any unfairness resulting from the application of such a formula to nonresidents is thus arguably an "incidental" consequence of the implementation of a neutral principle, which is simply to say that all unfairness is not unconstitutional.[110] Furthermore, one could rely on the fact that the nonresident never actually pays any more Vermont tax than the resident, whether or not the nonresident pays at a higher rate. Hence, one might suggest that the nonresident's claim is at best an abstract complaint over how the Vermont levy should be conceptualized, that there is room for argument over its appropriate conceptualization, and that, since constitutional law is mired in conceptual quicksand anyway, the nonresident should not be entitled to relief unless he can show that he is demonstrably worse off than the resident.[111]

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[105] Allied Stores of Ohio, Inc. v. Bowers, 358 U.S. 522, 526 (1959).

[106] General Am. Tank Car Corp. v. Day, 270 U.S. 367 (1926).

[107] Toomer v. Witsell, 334 U.S. 385, 408 (1948) (concurring opinion).

[108] *E.g.*, Wheeling Steel Corp. v. Glander, 337 U.S. 562 (1949).

[109] Allied Stores of Ohio, Inc. v. Bowers, 358 U.S. 522, 527 (1959).

[110] As the Court stated in Salomon v. State Tax Commn., 278 U.S. 484, 491-92 (1929): "To all such objections it may be answered that minor inequalities and hardships are incidents of every system of taxation and do not render the legislation obnoxious to the Federal Constitution."

[111] Such as were the nonresident commercial fishermen in Toomer v. Witsell, 334

But these are feeble excuses in light of the purposes underlying Vermont's tax scheme. Vermont's basic tax structure was explicitly predicated on the idea that the resident and nonresident taxpayer with the same ability to pay ought to pay to Vermont the same percentage of their income taxable by Vermont. When Vermont imposed its proportional limitation it effectively destroyed this equality. While it is true that the maximum Vermont tax burden on either taxpayer is the same in absolute terms, the basis of the equality between them was never so conceived. The point is simply that Vermont should not be permitted to have it both ways. If it chooses to tax all taxpayers on the basis of the principle that those with the same ability to pay should pay taxes to Vermont at the same rate, it cannot in the next breath enact a statute that makes this principle "inoperative" with respect to high bracket taxpayers. If this is not a problem of constitutional significance,[112] it is nevertheless an inequity inconsistent with the salutary principle that lay at the heart of the Vermont statute.

IV. NONPROLIFERATION OF PROGRESSIVE RATES BASED ON INCOME WHEREVER EARNED

"Is there any point to which you would wish to draw my attention?"
"To the curious incident of the dog in the night-time."
"The dog did nothing in the night-time."
"That was the curious incident," remarked Sherlock Holmes.[113]

It is indeed curious that more than fifty years after the Supreme Court put its imprimatur on a progressive state tax structure that assessed nonresidents at rates determined in part by nontaxables,[114] only four jurisdictions[115] have adopted such a rate structure for their personal income tax systems. It is curious first because such a taxing scheme is as politically painless a method of garnering additional revenue as state legislators are likely to find. Indeed, taxing states have repeatedly been compelled by courts to demand *less* from non-

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U.S. 385 (1948), who were compelled to pay a license tax one hundred times as great as that imposed on residents.

[112] *But see* Smith v. Loughman, 245 N.Y. 486, 490, 157 N.E. 753, 756, *cert. denied*, 275 U.S. 560 (1927); Goodwin v. State Tax Commn., 286 App. Div. 694, 702, 146 N.Y.S.2d 172, 181 (1955), *affd. mem.*, 1 N.Y.2d 680, 150 N.Y.S.2d 203, 133 N.E.2d 711, *appeal dismissed*, 352 U.S. 805 (1956) (state cannot discriminate against nonresident in terms of rate).

[113] A. DOYLE, *Silver Blaze, The Memoirs of Sherlock Holmes* (1894), in THE COMPLETE SHERLOCK HOLMES 347 (n.d.).

[114] Maxwell v. Bugbee, 250 U.S. 525 (1919).

[115] MO. REV. STAT. ANN. § 143.041 (Supp. 1974); NEB. REV. STAT. § 77-2715 (Supp. 1973); R.I. GEN. LAWS ANN. § 44-30-33 (Supp. 1973); VT. STAT. ANN. tit. 32, § 5822 (1970). For a discussion of the former practice of territorial Alaska see note 133 *infra*.

residents than was their initial inclination,[116] and here was presented a constitutionally sanctioned method by which to demand *more*. It is also curious because a number of states that have hesitated to enact income taxes with rate structures such as that in question have nevertheless enacted similar structures with respect to death taxes.[117] Finally, it is curious because it is frequently administratively as easy —and occasionally administratively easier—to calculate the nonresident's rate on the basis of his income wherever earned as on his income earned within the state. It is therefore appropriate to inquire why most states have refrained from adopting a formula such as Vermont's[118] for their personal income tax.

Since there is no longer a serious question about the constitutional propriety of a progressive state tax structure that includes a nonresident's nontaxable out-of-state income in determining the rate at which he will pay,[119] a state's choice of such a structure is fundamentally an issue of policy. To determine whether there are any substantial policy reasons for not adopting this approach to the taxation of nonresidents, it is first necessary to identify the policies underlying a state's existing tax system. Forty-four states and the District of Columbia impose a tax on personal income.[120] Three states impose their tax only on residents and only on a limited category of income.[121] Two states impose a so-called "commuter's tax,"[122] an ingenious if constitutionally questionable[123] scheme designed by states without general income taxes of their own. The states increase their revenues through a "sponge" tax that, by effectively taxing only nonresidents who work in the state, absorbs the income tax credits allowed by neighboring states for taxes paid to "other" states.[124] Of the remaining forty-one jurisdictions that impose a general income tax, only one, the District of Columbia, fails to tax nonresident income,[125] a predictable result of the fact that the body that legislates for the District is more representative of nonresidents who work there than of District residents themselves.[126] The forty states that do tax nonresident income on a broad basis do so in a variety of ways.

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[116] *See, e.g.*, Toomer v. Witsell, 334 U.S. 385 (1948); Travis v. Yale & Towne Mfg. Co., 252 U.S. 60 (1920); Ward v. Maryland, 79 U.S. (12 Wall.) 418 (1870).

[117] *See* note 137 *infra*.

[118] The reference, of course, is only to the basic Vermont taxing scheme discussed in Part II *supra*; it is not intended to include the wrinkle added by Vermont's proportional ceiling discussed in Part III *supra*.

[119] *See* Alaska S.S. Co. v. Mullaney, 180 F.2d 805, 822-23 n.23 (9th Cir. 1950); Wheeler v. State, 127 Vt. 361, 249 A.2d 887, *appeal dismissed*, 396 U.S. 4 (1969). *Cf.* Great Atl. & Pac. Tea Co. v. Grosjean, 301 U.S. 412 (1937); Maxwell v. Bugbee, 250 U.S. 525 (1919); Rigby v. Clayton, 2 N.C. App. 57, 162 S.E.2d 682, *affd.*, 274 N.C. 465, 164 S.E.2d 7 (1968). *See generally* Part II *supra*.

[120] Only Florida, Nevada, South Dakota, Texas, Washington, and Wyoming impose no personal income taxes. 1 P-H STATE AND LOCAL TAXES (All States Unit) ¶ 101, at 104 (1974).

[121] New Hampshire and Tennessee impose a tax on intangibles. N.H. REV. STAT. ANN. §§ 77:1-17, :17-a, :18-23, :27-29, :30-a-36 (1970), :24-25-a, :30 (Supp. 1973); TENN. CODE ANN. §§ 67-2603-06, -2608, -2610-12, -2615-17 (1955), -2601-02, -2607, -2609, -2613-14, -2618-35 (Supp. 1973). Connecticut imposes a tax on capital gains. CONN. GEN. STAT. ANN. §§ 12-506a-07, -509-22 (1958), -505-06, -508 (Supp. 1973).

[122] N.H. REV. STAT. ANN. §§ 77-B:2-3, :5-21, :24-28 (1970), :1, :4, :22-23 (Supp. 1973); N.J. REV. STAT. ANN. §§ 54:8A-1-118 (Supp. 1973).

[123] *See* J. HELLERSTEIN, *supra* note 11, at 614; *but see* Austin v. State Tax Commn., — N.H. —, 316 A.2d 165, prob. juris. noted, 43 U.S.L.W. 3208 (U.S. Oct. 15, 1974) (upholding constitutionality of New Hampshire's commuter's tax).

My concern here, however, is not with differences in detail but with the key political choices bearing on states' treatment of the nonresident for personal income tax purposes. One critical choice is between a progressive and a proportional income tax system. As suggested above,[127] such a choice involves a fundamental policy determination whether it is fairer to demand from each taxpayer the same share of his income or to demand increasingly larger shares from those who earn more. Five states have adopted a proportional approach in their income tax systems.[128] Since rate is then no longer a function of income, the problem of increasing the rate by reference to nontaxables evaporates. The nonresident and the resident simply pay the same portion of their taxable income to the state, at the single rate the state has established.

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[124] *See generally* Day, *Taxing Interstate Commuters: A New Jersey Experiment Under the United States Constitution*, 18 Rutgers L. Rev. 1 (1963). The commuter's tax is no different in principle from those state death taxes designed to absorb the federal estate tax credit for inheritance, estate, or other state succession taxes. 26 U.S.C. § 2011 (1970). *See* note 137 *infra*.

[125] D.C. Code Ann. § 47-1567 (1973). However, nonresidents are subject to the District's "Unincorporated Business Tax." D.C. Code Ann. § 47-1574 (1973).

[126] The recent grant of "home rule" to the District, Pub. L. No. 93-198, 87 Stat. 774 (Dec. 24, 1973), explicitly withholds from the governing council the authority to "impose any tax on the whole or any portion of the personal income, either directly or at the source thereof, of any individual not a resident of the District . . . ." Pub. L. No. 93-198, § 602(a)(5), 87 Stat. at 813.

[127] *See* text accompanying note 83 *supra*.

[128] Ill. Rev. Stat. ch. 120, § 2-201(b) (1973) (2.5 per cent of taxable net income); Ind. Ann. Stat. § 6-3-2-1(a) (Supp. 1973) (2 per cent of adjusted gross income); Mass. Ann. Laws ch. 62, § 4 (Supp. 1972) (5 per cent of earned income and annuities; 9 per cent of interest, dividends, and net capital gains); Mich. Stat. Ann. § 7.557(151) (Supp. 1973) (3.9 per cent of adjusted gross income); Pa. Stat. Ann. tit. 72, § 7302 (Supp. 1973) (2.3 per cent of specified classes of taxable income). In several instances, this "choice" was compelled by state court decisions holding that an income tax is a property tax and that graduated rates therefore violate the uniformity and equality provisions of state constitutions. *See In re* Opinion of the Justices, 220 Mass. 613, 108 N.E. 570 (1915); Kelley v. Kalodner, 320 Pa. 180, 181 A. 598 (1935); *cf.* Thorpe v. Mahin, 43 Ill. 2d 36, 250 N.E.2d 633 (1969), *overruling* Bachrach v. Nelson, 349 Ill. 579, 182 N.E. 909 (1932).

The other thirty-five jurisdictions that impose general income taxes on residents and nonresidents have tax systems with at least some measure of progressivity.[129] Although in several instances the progressive element of the rate structure may be regarded as de minimis,[130] each of these jurisdictions must determine (and, of course, has by statute declared) whether a nonresident's income tax rate will be based on in-state or on both in-state and out-of-state income. Among these states, only Alaska has refrained from taxing even its residents on income earned from sources outside the state.[131] Obviously any attempt by Alaska to reckon a nonresident's tax rate with reference to his total income would be improper unless the same were done with respect to residents. The remaining thirty-four jurisdictions, however, tax residents on their income wherever earned and nonresidents on income from sources within the state.[132] Four of these do in fact look to out-of-state income in fixing a nonresident's income tax rate.[133] Hence thirty states, although not constitutionally

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129. *See* 1 P-H STATE AND LOCAL TAXES (All States Unit) ¶ 1007 (1974); CCH STATE TAX GUIDE (All States Unit) ¶ 15,000, at 1531-34 (1974).

130. Mississippi, for example, imposes an income tax at the rate of 3 per cent on the first $5,000 of taxable income and 4 per cent for all taxable income in excess of $5,000. MISS. CODE ANN. § 27-7-5 (1972).

131. ALAS. STAT. § 43.20.010(a) (1971). Both the measure and rate of the taxes are likewise determined solely on the basis of income from sources within the state.

132. ALA. CODE tit. 51, § 377 (1958); ARIZ. REV. STAT. ANN. § 43-102(a) (Supp. 1973); ARK. STAT. ANN. § 84-2003 (Supp. 1973); CAL. REV. & TAX CODE ANN. § 17041 (Supp. 1974); COLO. REV. STAT. ANN. §§ 138-1-9, -15 (Supp. 1965); DEL. CODE ANN. tit. 30, § 1102 (Supp. 1970); GA. CODE ANN. § 92-3101 (Supp. 1973); HAWAII REV. STAT. § 235-4 (Supp. 1973); IDAHO CODE ANN. § 63-3024 (Supp. 1973); IOWA CODE § 422.5 (1971); KAN. STAT. ANN. §§ 79-32,110, 117 (Supp. 1972), 116, 122, 123 (1969); KY. REV. STAT. ANN. §§ 14.020(1), (4) (Supp. 1972); LA. REV. STAT. ANN. § 47:31 (1970); ME. REV. STAT. ANN. tit. 36, § 5111 (Supp. 1973); MD. ANN. CODE art. 81, §§ 280(a), 287, 288, 291(a) (1969); MINN. STAT. ANN. §§ 290.01(22) (1962), .17 (Supp. 1974); MISS. CODE ANN. §§ 27-7-5 (1972), -15 (Supp. 1973); MO. STAT. ANN. §§ 143.041, .121 (Supp. 1974); MONT. REV. CODES ANN. §§ 84-4902, -4903 (Supp. 1973); NEB. REV. STAT. § 77-2715 (Supp. 1973); N.M. STAT. ANN. § 72-15A-3 (Supp. 1973); N.Y. TAX LAW §§ 611 (1966), 612, 631-32 (Supp. 1973); N.C. GEN. STAT. § 105-136 (1972); N.D. CENT. CODE §§ 57-38-02, -03 (1972); OHIO REV. CODE §§ 5747.02, .20 (1973); OKLA. STAT. ANN. tit. 68, §§ 2353(12), 2355(A), 2362 (Supp. 1973); ORE. REV. STAT. § 316.037 (1971); R.I. GEN. LAWS ANN. §§ 44-30-1, -12, -32 (Supp. 1972); S.C. CODE § 65-221 (1962); UTAH CODE ANN. §§ 59-14A-5, -11, -15 (Supp. 1973); VA. CODE ANN. §§ 58-151.013(a), (f) (Supp. 1973); VT. STAT. ANN. tit. 32, §§ 5822 (1970), 5823 (Supp. 1973); W. VA. CODE ANN. §§ 11-21-4b, -12 (Supp. 1973), -31 (1966); WIS. STAT. ANN. §§ 71-.01, -.02 (1969).

133. *See* note 115 *supra*. Alaska, when it was still a territory, had adopted a progressive rate structure that assessed nonresidents on their Alaska income at rates determined by their income from all sources. Alas. Sess. Laws 1949, ch. 115, § 5A(a). The provisions are set out and discussed in Alaska S.S. Co. v. Mullaney, 180 F.2d 805, 809 n.1, 822-23 n.23 (9th Cir. 1950). Alaska's present income tax law, however, contains no such provision and imposes a tax on both residents and nonresidents of 16 per cent of a taxpayer's federal tax liability "upon all income derived from sources within the state." ALAS. STAT. § 43.20.010(a) (1971). Alaska has a particularly troublesome problem in the taxation of nonresidents or part-year residents who come to Alaska during

compelled to do so, base their progressive rates only on a nonresident's in-state income, despite the fact that doing so deprives them of revenue they would otherwise have collected[134] and fails to reflect the taxpayer's total ability to pay.

What explanation is there for this self-restraint? It is conceivable that the state legislatures were persuaded by the argument that it is fundamentally inequitable for a state to increase a nonresident's tax bill as a result of activities carried on elsewhere. There are at least three reasons that make this explanation unlikely. First, as discussed in connection with the *Wheeler* case,[135] there are equally compelling policy arguments that support such a rate structure. It treats people with the same ability to pay similarly for state tax purposes and does not allow jurisdictional boundaries to provide the multistate taxpayer with an escape from progressivity. Additionally, when forced to choose between fairness to outsiders and increased revenue for themselves,

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the warmer months and of merchant seamen based elsewhere who work in Alaskan waters. *See* Alaska S.S. Co. v. Mullaney, 180 F.2d 805 (9th Cir. 1950); State of Alaska v. Petronia, 69 Wash. 2d 400, 418 P.2d 755 (1966), *appeal dismissed*, 389 U.S. 7 (1967). In light of this, one must wonder what prompted the Alaska legislature to change its tax laws so as to reduce even further the tax revenues it derives from non- or part-year residents.

[134] Arguably, since every state (except Alaska) imposing a general income tax allows its residents a credit for income taxes paid to other states, CCH STATE TAX GUIDE (All States Unit) ¶ 15-000, at 1543 (1974) (chart), a state's decision to increase its tax rate, and, hence, tax yield, with respect to nonresidents would simply siphon off a corresponding amount of revenue from the nonresident's home state, which would allow him a credit for whatever taxes he paid as a nonresident. But this very likely would not occur to the extent that the taxing state had higher tax rates than the nonresident's home state or taxed some sources of income not taxed by the nonresident's home state. *See* Note, *supra* note 13, at 981-85. Moreover, this would clearly not be true of those states that tax nonresidents who are residents of states with no general income tax. A glance at the map reveals that the ten states that apply no general income tax of their own, *see* notes 120-22 *supra*, are bordered by twenty-nine jurisdictions that do impose such taxes, twenty-seven of which use progressive rates, *see* notes 128-29 *supra* and accompanying text, and twenty-three of which look only to in-state income for determining the rate at which a nonresident pays income taxes. These are: Alabama (Florida, Tennessee), Arizona (Nevada), Arkansas (Tennessee, Texas), California (Nevada), Colorado (Wyoming), Delaware (New Jersey), Georgia (Florida, Tennessee), Idaho (Nevada, Washington, Wyoming), Iowa (South Dakota), Kentucky (Tennessee), Louisiana (Texas), Maine (New Hampshire), Minnesota (South Dakota), Mississippi (Tennessee), Montana (South Dakota, Wyoming), New Mexico (Texas), New York (Connecticut, New Jersey), North Carolina (Tennessee), North Dakota (South Dakota), Oklahoma (Texas), Oregon (Nevada, Washington), Utah (Nevada, Wyoming), Virginia (Tennessee). In addition to the individual who lives in a state without a general income tax and works in a state with such a tax, any resident of the former type of jurisdiction deriving income from property owned in the latter type of jurisdiction would in most cases contribute to the aggregate net tax yield of the states were he taxed at progressive rates on the basis of his entire income. Furthermore, the traveling salesman or merchant seaman residing in a state without a general income tax may nevertheless earn income taxable by a number of states that do not border on his own. *See* State of Alaska v. Petronia, 69 Wash. 2d 460, 418 P.2d 755 (1966), *appeal dismissed*, 389 U.S. 7 (1967).

[135] *See* text accompanying notes 57-79 *supra*.

the states have not unnaturally tended to give themselves the benefit of the doubt.[136] Third, seventeen of the thirty states that have refrained from reckoning their progressive *income* tax rates in terms of a nonresident's total income wherever earned nevertheless determine their progressive *death* tax rates in terms of a nonresident decedent's entire estate wherever situated.[137] There is no meaningful distinction between income and death taxes for purposes of such a rate structure;[138] thus the disparity is puzzling.

A second possible justification for the states' hesitation to look to a nonresident's out-of-state income for purposes of their progressive rate structure is that doing so would entail administrative burdens that outweigh the revenue that might be gained. This contention does not withstand analysis. Even if one is prepared to argue that minimizing the number of computations required of a nonresident relieves state tax authorities of administrative problems serious enough to justify foregoing otherwise obtainable state revenue,[139] the truth is that in many instances the nonresident will have had to make such computations anyway. Every one of the thirty states[140] that permit the nonresident to compute his tax with respect only to in-state income nevertheless requires him to compute the percentage that his in-state income bears to his total income for purposes of state deductions, exemptions, or credits.[141] Thus, in most instances the nonresident is required to carry out the very calculations he would have had to make were he compelled to compute his state tax at a progressive rate determined with reference to his total income. In short, an argument based on easing the administrative burden is pure hokum.

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[136] *See* cases cited in note 104 *supra*.

[137] Ala. Code. tit. 51, § 438 (1958); Ark. Stat. Ann. § 63–104 (1971); Ga. Code Ann. § 92-3402 (1961); Hawaii Rev. Stat. § 236–14 (Supp. 1973); Iowa Code § 451.2 (1971); Kan. Stat. Ann. § 79–1501a (1969), Kan. Admin. Regs. § 92–2–23, reported in 1 CCH Inh. Est. & Gift Tax Rep. 27,243 (1966); Ky. Rev. Stat. Ann. § 140.130 (1971); Minn. Stat. Ann. § 291.34 (1972); Mont. Rev. Codes Ann. § 91–4411(a) (Supp. 1973); N.M. Stat. Ann. § 72–33–4 (Supp. 1973); N.Y. Tax Law § 960 (1966); N.C. Gen. Stat. § 105–21 (1972); Ohio Rev. Code § 5731.19 (1973); Okla. Stat. Ann. tit. 68, § 804 (1966); S.C. Code § 65–481 (Supp. 1971); Utah Code Ann. § 59–12–2(2) (Supp. 1973); Va. Code Ann. § 58–193.1 (Supp. 1973).

Many of these statutory provisions are designed principally to take full advantage of the federal estate tax credit allowed for payment of state death taxes. 26 U.S.C. § 2011 (1970). These "sponge" taxes, so denominated because they are designed to "absorb" the federal credit, *cf.* text accompanying notes 122-24 *supra*, generally impose a tax equal to the maximum amount of credit allowed under section 2011 of the Internal Revenue Code. With respect to nonresidents, the tax generally equals that proportion of the allowable federal credit defined by the ratio of the property taxable in the taxing state to the value of the entire estate wherever located. Since the federal credit is graduated according to the federal taxable estate, any state tax formula designed to absorb a proportionate part of the credit will have the same effect as the tax formula employed in *Wheeler*—namely, raising the state tax by considering nontaxables for rate purposes. This assumes, of course, that the nontaxables (for example, out-of-state realty or tangible personalty) constitute part of the taxable estate and that these are sufficient to raise the effective rate of the allowable credit.

[138] *See* Alaska S.S. Co. v. Mullaney, 180 F.2d 805, 822-23 n.23 (9th Cir. 1950); *cf.* Smith v. Loughman, 245 N.Y. 486, 157 N.E. 753, *cert. denied*, 275 U.S. 560 (1927).

[139] While this is obviously a policy judgment, it is difficult to perceive exactly what administrative problems the legislators might have had in mind, particularly in light of the byzantine complexities that many of these states have without hesitation introduced into other aspects of their tax systems.

[140] *See* text accompanying notes 132-34 *supra*.

Finally, it is possible that states have refrained from taxing nonresidents at a rate determined by their entire income for fear that doing so would precipitate retaliatory action by other states, resulting in higher taxes imposed upon the out-of-state income of their own residents.[142] Whether such a fear is justified depends upon such factors as whether neighboring jurisdictions imposed an income tax,[143] the rate structure of such a tax, and whether the state was primarily a source of supply or demand for out-of-state labor and capital.

In sum, while there may be rational explanations for the states' failure to adapt their progressive rate structures to the nonresident's full ability to pay, for the most part such explanations appear to have had little real effect in shaping statutory patterns. More likely, the legislators gave little, if any, thought to considerations such as those raised here. If they had, perhaps they would have done something about the problems involved. If they now do, perhaps they will. The arguments in favor of jurisdictionless ability to pay as the basis of a state tax structure may in many instances outweigh those that can be marshalled against it. However the issue may ultimately be resolved, it is better that the resolution be the outcome of deliberate decision-making rather than the result of unwitting neglect.

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[141] Ala. Code tit. 51, §§ 385 (1958), 388 (Supp. 1973) (deductions, exemptions); Ariz. Rev. Stat. Ann. § 43-128(b) (Supp. 1973) (credits); Ark. Stat. Ann. §§ 84-2020, -2021(e) (1960) (deductions, credits); Cal. Rev. & Tax Code Ann. §§ 17055, 18002(c) (1970) (deductions, exemptions, credits); Colo. Rev. Stat. Ann. § 138-1-15 (Supp. 1965) (deductions, exemptions); Del. Code Ann. tit. 30, § 1126 (Supp. 1972) (deductions, exemptions); Ga. Code Ann. § 92-3112(d) (1961) (deductions, exemptions); Hawaii Rev. Stat. § 235-5(c) (1968) (deductions); Idaho Code Ann. §§ 63-3027(t), -3029(b) (Supp. 1973) (deductions, exemptions, credits); Iowa Code § 422.9 (1971) (deductions "fairly and equitably allocable to Iowa under the rules and regulations prescribed by the director"; *see* Iowa Departmental Rules § 22.9-12 (1971)); Kan. Stat. Ann. §§ 79-32, 126(b)-127 (1969) (deductions, exemptions); Ky. Rev. Stat. Ann. § 141.020(3)(b) (Supp. 1972) (credits); La. Rev. Stat. Ann. §§ 47:79(E) (1970), :243 (Supp. 1974) (exemptions, deductions ("ratable portion")); Me. Rev. Stat. Ann. tit. 36, § 5144 (Supp. 1973) (deductions); Md. Code Ann. art. 81, §§ 286(h), 291(a) (1969) (exemptions, deductions, credits); Minn. Stat. Ann. §§ 290.06(3a)-(c), (7), .081(b) (Supp. 1974) (deductions, credits); Miss. Code Ann. § 27-7-21(i) (Supp. 1973) (exemptions); Mont. Rev. Codes Ann. § 84-4910(i) (1966) (exemptions); N.M. Stat. Ann. § 72-15A-12 (Supp. 1973) (credits); N.Y. Tax Law § 636 (Supp. 1973) (exemptions); N.C. Gen. Stat. § 105-149(b) (1972) (exemptions); N.D. Cent. Code § 57-38-06.1 (1972) (exemptions); Ohio Rev. Code § 5747.05(A)(2) (1973) (credits); Okla. Stat. Ann. tit. 68, § 2362 (Supp. 1973) (deductions, exemptions); Ore. Rev. Stat. § 316.117 (1971) (deductions, exemptions); S.C. Code § 65-225(6) (1962) (exemptions); Utah Code Ann. § 59-14A-5 (Supp. 1973) (determination of Utah taxable income); Va. Code Ann. § 58-151.013(f), -.015(b) (Supp. 1973) (determination of Virginia taxable income, credits); W. Va. Code Ann. § 11-21-40 (1966) (credits); Wis. Stat. Ann. §§ 71.02(2)(a) (1969), .02(2)(f), (gp) (Supp. 1973) (deductions).

[142] The Report of the New Jersey Tax Policy Committee, Part V, Non-Property Taxes in a Fair and Equitable Tax System 93 (1972) takes this position.

[143] *See* note 134 *supra*.

V. EXEMPTIONS, DEDUCTIONS, AND CREDITS

The considerations underlying the nonresident's relationship to the taxing jurisdiction are germane to several other issues arising in connection with the income taxation of nonresidents. It may therefore be useful to examine briefly, in light of the factors discussed above, some of the recurring problems involving the allowance or disallowance of exemptions, deductions, and credits to nonresidents under state income tax statutes.

The guiding constitutional principles were enunciated in *Shaffer v. Carter*,[144] which definitively established the state's right to tax the income of nonresidents, and the companion case of *Travis v. Yale & Towne Manufacturing Co.*[145] In *Shaffer*, the appellant, while broadly challenging the state's power to tax the income of nonresidents, also contended that Oklahoma's statute violated the privileges and immunities and equal protection clauses because it permitted residents to deduct losses wherever incurred but allowed nonresidents to deduct only losses incurred within the state. To this claim the court responded:

> The difference, however, is only such as arises naturally from the extent of the jurisdiction of the State in the two classes of cases, and cannot be regarded as an unfriendly or unreasonable discrimination. As to residents it may, and does, exert its taxing power over their income from all sources, whether within or without the State, and it accords to them a corresponding privilege of deducting their losses, wherever these accrue. As to nonresidents, the jurisdiction extends only to their property owned within the State and their business, trade, or profession carried on therein, and the tax is only on such income as is derived from those sources. Hence there is no obligation to accord to them a deduction by reason of losses elsewhere incurred.[146]

On the same day, however, the Court in *Travis* held unconstitutional the provision of the New York income tax statute that denied to nonresident taxpayers the personal exemption granted resident taxpayers:

> Whether they must pay a tax upon the first $1,000 or $2,000 of income, while their associates and competitors who reside in New York do not, makes a substantial difference. Under the circumstances

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[144] 252 U.S. 37 (1920).

[145] 252 U.S. 60 (1920).

[146] 252 U.S. at 57.

> as disclosed, we are unable to find adequate ground for the discrimination, and are constrained to hold that it is an unwarranted denial to the citizens of Connecticut and New Jersey of the privileges and immunities enjoyed by citizens of New York. This is not a case of occasional or accidental inequality due to circumstances personal to the taxpayer . . . but a general rule, operating to the disadvantage of all non-residents including those who are citizens of the neighboring States, and favoring all residents including those who are citizens of the taxing State.[147]

The half century of judicial interpretation and legislative implementation of *Shaffer* and *Travis* with respect to the allowance or disallowance of exemptions, deductions, and credits to nonresidents has been marked by confusion and inconsistency. The final section of this article addresses some of the questions raised by these decisions and statutes.

A. *Personal Exemptions, Deductions, and Credits*[148]

While the Supreme Court made it clear in *Travis* that the privileges and immunities clause prohibited the complete denial to nonresidents of personal exemptions allowed residents, it left unanswered the question whether the taxing state must grant nonresidents the full exemptions allowed residents or may instead grant only that portion of the exemption defined by the ratio of the nonresident's in-state income to his income from all sources. Although some states allow the nonresident the full exemption,[149] most require that it be proportionately reduced.[150] The case law on the issue is sparse, divided, and unilluminating.[151]

The essential question is whether a proportional exemption, which in absolute terms is less than the exemption granted residents, operates to the "disadvantage" of nonresidents.[152] The answer depends on what criterion one uses to determine whether residents and nonresidents are receiving equal treatment. If the issue is framed in terms of the state's power to tax, one can argue that the proportionate exemption simply recognizes the more limited jurisdiction that the state exercises over the nonresident's income, and that the difference in treatment is therefore rational and fair.[153] On the other hand, it can be argued that the jurisdictional bases for taxing residents and nonresidents are not relevant to the considerations bearing on a state's decision to grant personal exemptions.

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[147] 252 U.S. at 80–81.

[148] This category includes all allowances, whether denominated exemptions, deductions, or credits, that permit the taxpayer to reduce his taxable income or his tax solely on the basis of his personal status and without regard to any expenses incurred.

[149] *See* Hawaii Rev. Stat. § 235–5(c) (1968); Me. Rev. Stat. Ann. tit. 36, § 5145 (Supp. 1973); W. Va. Code Ann. § 11–21–36 (1966).

[150] *See, e.g.*, Ark. Stat. Ann. § 84–2021(e) (1960); Del. Code Ann. tit. 30, § 1126 (Supp. 1972); Ill. Rev. Stat. ch. 120, § 2–204 (1973). *See also* note 141 *supra*.

[151] *Compare* Reynolds Metal Co. v. Martin, 269 Ky. 378, 384, 402, 107 S.W.2d 251, 252-53, 263 (Spec. Ct. App. 1937) *with* State v. Burnett, 200 Ark. 655, 140 S.W.2d 673 (1940); *cf.* State *ex rel.* Haworth v. Berntsen, 68 Idaho 539, 200 P.2d 1007 (1948); State *ex rel.* McCulloch v. Ashby, 73 N.M. 267, 387 P.2d 588 (1963); McCutchan v. Oklahoma Tax Commn., 191 Okla. 578, 132 P.2d 337 (1942).

[152] Travis v. Yale & Towne Mfg. Co., 252 U.S. 60, 81 (1920).

Personal exemptions represent a political determination that a portion of a taxpayer's income should be immune from tax liability solely on the basis of his personal status and without regard to any expenses he might have incurred. They reflect the view that until a taxpayer's earnings reach a certain level he ought not be required to contribute to the costs of government. In addition, because of the problems that would arise if individuals above a certain income level were required to pay taxes on *all* their income, including that below the exemption level, personal exemptions are almost invariably granted to all taxpayers, regardless of their income.[154]

If the issue is reframed in light of the purpose of granting personal exemptions, the search for a persuasive justification for reducing the nonresident's exemption on the basis of income earned elsewhere becomes more troublesome. Since the amount of income a resident earns plays no role in determining whether he receives a full exemption, it should not play any role in determining whether a nonresident receives a full exemption. Moreover, it may be suggested that the source of one's income bears no more rational relationship to the purposes of granting personal exemptions than does its amount. Indeed, the fact that the resident's personal exemption does not vary according to the source of his earnings demonstrates that the state has determined that there is no necessary relationship between the amount of the exemption and the source of the taxpayer's income.[155]

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[153] Culp, *Selected Problems in Multistate Taxation*, 44 Iowa L. Rev. 280, 292-93 (1959).

[154] Blum & Kalven, *The Anatomy of Justice in Taxation*, in Occasional Papers from the Law School of the University of Chicago 11-12 (1973). Blum and Kalven provide the following illustration of the effect of giving an exemption only to those below the cutoff point and none to those above the cutoff point:

> [A]ssume an exemption of $5,000 and a flat rate of 25 percent. A man with an income, say, of $4,000 or $4,500 or $5,000 will pay nothing in taxes; but a man with a slightly larger income, say, of $5,100 or $5,500 or $6,000 will end up literally worse off after taxes than if he initially had had an income under $5,000. Indeed, the system will find itself using a marginal rate of tax on that additional $100, $500, or $1,000 that is over 100 percent.

Id. at 12.

[155] Solomon, *Nonresident Personal Income Tax: A Comparative Study in Eight States*, 29 Fordham L. Rev. 105 (1960), declares flatly that "[p]ersonal exemptions, have no relation to . . . the source of [a taxpayer's] income," and construes *Travis* as holding that "a state must afford nonresidents and residents the same personal exemptions." *Id.* at 108. For reasons set forth in the text, this would appear to oversimplify the problem. *See* McCutchan v. Oklahoma Tax Commn., 191 Okla. 578, 132 P.2d 337 (1942) (per-

On the other hand, if source is a fair measure of a nonresident taxpayer's relationship to the state, as has generally been assumed, it is not unreasonable to argue that, to the extent that his activities are carried on elsewhere, his need for and claim to a minimum level of income free from tax in the taxing jurisdiction is accordingly diminished.

Another approach to the question is grounded in neither the jurisdictional bases for the taxation of nonresidents nor the underlying purposes of the personal exemption. One can examine the question from the standpoint of achieving an equality of tax rates between residents and nonresidents. Depending on whether one defines rate equality with respect to income from all sources or with respect only to income taxable by the state—a distinction that lay at the heart of the dispute in *Wheeler*—the proportional personal exemptions for nonresidents may or may not find support. If rate equality is viewed in terms of a taxpayer's income from all sources, it is furthered more by the use of proportional exemptions than by the use of full exemptions.[156] If, however, rate equality is viewed in

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sonal exemptions apportioned to income earned within state for residents and nonresidents alike); *see also* Culp, *supra* note 152, at 292-93.

[156] The following example illustrates the point: Assume the effective tax rate (whether proportional or graduated) on a resident and nonresident taxpayer, each earning $10,000, is 10 per cent without consideration of any exemptions. Assume further that the nonresident earns only half his income in the taxing state and that a full personal exemption amounts to $1,000. The effect of allowing the nonresident a full or a proportional exemption is as follows:

	Resident	Nonresident	
		Full exemption	*Proportional exemption*
Taxable income from all sources before exemption	$10,000	$10,000	$10,000
Tax rate (based on income from all sources or proportional)	10%	10%	10%
Income constitutionally taxable by state before exemption	10,000	5,000	5,000
Exemption	1,000	1,000	500
Taxable income	9,000	4,000	4,500
Tax	900	400	450
Tax as percentage of income constitutionally taxable by state before exemption	9%	8%	9%

Moreover, if allowing a nonresident a full exemption in a graduated rate structure were to lower the nonresident's effective tax rate, this would exacerbate the rate inequality between resident and nonresident in terms of their total income. This problem, of course, would not arise in a proportional system.

terms solely of the taxpayer's income that is constitutionally taxable by the state, full exemptions for nonresidents obviously have a greater tendency to achieve equality than proportional exemptions.[157] While framing the question in terms of rate equality provides no definitive answer, identification of the assumptions about rate equality that underlie—or ought to underlie—a state's tax system may suggest a resolution of the issues involved.[158]

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[157] On this assumption, the appropriate comparison would be between the hypothetical nonresident in note 156 *supra* and a resident who earned $5,000 taxable income from all sources before an exemption.

	Resident	Nonresident	
		Full exemption	*Proportional exemption*
Taxable income from all sources before exemption	$5,000	$10,000	$10,000
Income constitutionally taxable by state before exemption	5,000	5,000	5,000
Tax rate (based on income constitutionally taxable by state or proportional)	10%	10%	10%
Exemption	1,000	1,000	500
Taxable income	4,000	4,000	4,500
Tax	400	400	450
Tax as percentage of income constitutionally taxable by state before exemption	8%	8%	9%

[158] The discussion in the text has focused on the impact of the personal exemption upon the effective rate at which an individual pays his tax. A related question—though one not limited to the treatment of residents vis-à-vis nonresidents—is the impact of marginal rates in a progressive tax system upon the effect of a personal exemption. The Report of the New Jersey Tax Policy Committee, *supra* note 142, summarized the problem:

> [P]erhaps the most important question concerning the exemption is how it should be implemented, through a deduction or a tax credit. By allowing the exemption in the form of a deduction, the tax benefit of the deduction varies as income increases, being the amount of the deduction times the marginal tax rate. Accordingly, as income increases the graduated rate results in the tax benefit of the deduction being increased. A method of controlling the effect of having a deduction coming off the highest rate bracket rather than the lowest is to state the deduction as a credit. Thus, the tax benefit from the personal exemption would be the same for all families of the same size. What this means is that the credit can be fixed in conjunction with the tax rate so as to exempt a fixed amount of income for persons in various family situations.

Id. at 91. A few states have framed their personal exemptions as tax credits, *see, e.g.*, Ark. Stat. Ann. § 84-2021 (Supp. 1973); Iowa Code § 422.12 (1971); Ky. Rev. Stat. Ann. § 141.020(3) (Supp. 1972), but the great majority allow a deduction from gross income. *See also* Weidenbaum, *The Advantages of Credits on the Personal Income Tax*, 42 Geo. Wash. L. Rev. 516 (1974).

B. *Deduction for Expenses*

1. *Expenses Incurred in Connection with the Production of Income*

Shaffer v. Carter[159] established and *Travis v. Yale & Towne Manufacturing Co.*[160] reiterated the principle that a state may limit the nonresident's deduction of expenses, losses, and the like to those incurred in connection with the production of income within the taxing state. At least insofar as the expenses relate to the nonresident's efforts to earn income, the proposition is eminently reasonable, because the state's jurisdiction to tax such income is similarly confined. Most state income tax statutes specify the criteria and methods the nonresident taxpayer must follow in allocating or apportioning to the taxing state expense deductions associated with income producing activities in that state.[161] While the relation of a particular expense item to activity in the taxing state may present troublesome factual questions, the controlling legal doctrine is both settled and sensible.

2. *Expenses Not Incurred in Connection with the Production of Income*

When we consider expenses *not* incurred in connection with the production of income, the controlling legal doctrine may be just as settled, but one may question whether it is as sensible. *Shaffer* and *Travis*, read literally, justify a state's refusal to allow a nonresident even a proportionate share of the various personal deductions allowed residents: "That there is no constitutional discrimination against citizens of other States in confining the deduction of expenses, losses, etc., in the case of non-resident taxpayers, to such as are connected with income arising from sources within the taxing State, likewise is settled by [*Shaffer v. Carter*]."[162] A number of states have invoked this language to deny nonresidents personal deductions,[163] and state courts have predictably sustained such legislation.[164]

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[159] 252 U.S. 37, 56-57 (1920).

[160] 252 U.S. 60, 75-76 (1920).

[161] *See, e.g.*, CAL. REV. & TAX CODE ANN. § 17301 (1970); GA. CODE ANN. § 92-3112(d) (1961); IOWA CODE § 422.9 (1971). *See also* note 142 *supra*.

[162] Travis v. Yale & Towne Mfg. Co., 252 U.S. 60, 75-76 (1920).

[163] *See, e.g.*, MONT. REV. CODES ANN. § 84-4907 (Supp. 1973); N.C. GEN. STAT. § 105-147(18) (1972); S.C. CODE § 65-264.1 (Supp. 1973). However, many states allow the nonresident to deduct a proportionate share of his personal expenses. *See, e.g.*, DEL. CODE ANN. tit. 30, § 1124 (Supp. 1970); GA. CODE ANN. § 92-3112(d) (1961); HAWAII REV. STAT. § 235-5(c) (1968).

[164] *See* Goodwin v. State Tax Commn., 286 App. Div. 694, 146 N.Y.S.2d 172 (1955), *affd. mem.*, 1 N.Y.2d 680, 150 N.Y.S.2d 203, 133 N.E.2d 711, *appeal dismissed*, 352 U.S. 805 (1956); Stiles v. Currie, 254 N.C. 197, 118 S.E.2d 428 (1961); Wilson v. Department of Revenue, — Ore. —, 514 P.2d 1334 (1973), *appeal dismissed*, 42 U.S.L.W. 3608 (U.S.

Nevertheless, serious questions may be raised concerning the logic and fairness of a total denial of certain personal deductions. Although it makes perfect sense for a state to deny the nonresident taxpayer a deduction for an expense incurred in connection with the production of income outside the state, because such income is not taxable by the state and at the same time to allow a resident taxpayer a deduction for expenses incurred in connection with the production of income wherever earned, because all such income is taxable by the state, it does not follow that the allowability of deductions that are granted for reasons having nothing to do with income producing activity should also be determined by considerations relating to jurisdiction to tax income.

There is, of course, more to be said for a state's decision to deny personal deductions to nonresidents than the Supreme Court's declaration that a state may restrict a nonresident's deductions to those connected with income arising from sources within the state. Whether or not the Supreme Court intended its comments in *Shaffer* and *Travis* to apply to personal expense deductions,[165] a persuasive case can be made that the refusal to grant personal deductions to nonresidents is a legitimate expression of the different relationship of the resident and nonresident taxpayer to the taxing state.[166] The rationale was well stated in *Goodwin v. State Tax Commission*,[167] involving the denial by New York State to a New Jersey resident of deductions for real estate taxes, mortgage interest, medical expenses, and life insurance premiums: "The factor of residence has an obvious connection with the allowance of the deductions of a personal character which are under consideration here. The expenditures are properly associated with the place where the taxpayer resides. They

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April 29, 1974) (No. 73–1126); Berry v. State Tax Commn., 241 Ore. 580, 397 P.2d 780 (1964), *appeal dismissed*, 382 U.S. 16 (1965).

[165] In Goodwin v. State Tax Commn., 286 App. Div. 694, 146 N.Y.S.2d 172 (1955), *affd. mem.*, 1 N.Y.2d 680, 150 N.Y.S.2d 203, 133 N.E.2d 711, *appeal dismissed*, 352 U.S. 805 (1956), the court noted that one of the issues presented to the Supreme Court in *Travis* was the alleged discrimination against the nonresident who, unlike the resident, was forbidden from deducting real estate taxes on his home outside the taxing state. The New York court read the Supreme Court's statement in *Travis*, *see* text accompanying note 162 *supra*, as authoritatively settling the issue of whether the state could constitutionally deny personal deductions to nonresidents, 286 App. Div. at 698, 146 N.Y.S.2d at 177, although it went on to consider the problem on broader grounds. However, nothing in either the *Shaffer* or *Travis* opinions indicates whether the Court was addressing itself to personal as well as business deductions, and at least one judge has found it "impossible to determine whether the opinions referred to business losses and expenses or personal expenses." Berry v. State Tax Commn., 241 Ore. 580, 586, 397 P.2d 780, 783 (1964) (dissenting opinion), *appeal dismissed*, 382 U.S. 16 (1965).

[166] *See* text accompanying notes 57-68 *supra*.

[167] 286 App. Div. 694, 146 N.Y.S.2d 172 (1955), *affd. mem.*, 1 N.Y.2d 680, 150 N.Y.S. 2d 203, 133 N.E.2d 711, *appeal dismissed*, 352 U.S. 805 (1956).

all relate to the personal activities of the taxpayer and his personal activities must be deemed to take place in the State of his residence, the State in which his life is centered."[168] The court's statement reveals both the strengths and weaknesses of the rationale for disallowing the deductions. Undoubtedly, residence has "an obvious connection" with the personal activities of a taxpayer. This provides a basis for distinguishing between residents and nonresidents on grounds rationally related to the purposes underlying the grant of personal deductions. But there is nothing that compels the conclusion that this "obvious connection" is in all instances an *exclusive* one. Medical expenses may be regarded as "related" to all of a taxpayer's activities, and taxes on personal purchases or entertainment may be "deemed to take place" in the state where the purchases are made or the entertainment is enjoyed as much as in the state of residence.

The attempt to analyze the allowability of deductions to nonresidents entirely on the basis of a personal/business dichotomy thus paints with too broad a brush. Indeed, *Travis* itself demonstrates that the distinction cannot explain the results in all cases. Although the provision struck down there had denied personal *exemptions* rather than personal *deductions* to nonresidents,[169] the decision at minimum reveals that there are limits to the theory that nonresidents may be denied tax benefits permitted residents on the grounds that such benefits have no connection with income earned within the state and may be characterized as "personal." Perhaps a more equitable approach to determining whether the nonresident should be allowed deductions for his personal expenses would be to examine each expense on an individual basis: Those uniquely related to the state of residence would be denied, and those related to all of the taxpayer's activity would be allowed in the proportion that the activity, as measured by his income, was carried on in the taxing state.

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[168] 286 App. Div. at 701, 146 N.Y.S.2d at 180.

[169] *Travis* should be contrasted in this respect with Shaffer v. Carter, 252 U.S. 37 (1920), which can be read as indicating that states *may* deny personal *deductions* to nonresidents (*but see* note 165 *supra* and accompanying text). To be sure, there are a number of distinctions that can be made between personal exemptions and itemized personal deductions: The former are allowed to all taxpayers, at a flat amount, without regard to any expenditures he might make; the latter are allowed on a selective basis, in differing amounts, to those taxpayers who make specific expenditures. Also, the severity and extent of the impact of denying nonresidents exemptions are probably greater than the impact of denying them personal deductions. But query whether the apparently inconsistent position taken by the Court with respect to personal exemptions and deductions can be justified. The court in *Goodwin*, while noting that the Supreme Court saw no inconsistency between its *Travis* and *Shaffer* opinions, 286 App. Div. at 703, 146 N.Y.S.2d at 181, nevertheless tried to justify the distinction on the ground that personal exemptions must be considered in terms of rate and that the substance of *Travis* is that a state cannot constitutionally tax the income of nonresidents at higher rates than it taxes the income of residents. 286 App. Div. at 702, 146 N.Y.S.2d at 181. *See* text accompanying notes 148-58 *supra*. The *Goodwin* court did, however, obliquely acknowledge the inconsistency:

> It may well be that, if the question were reconsidered today in the light of the subsequent extension of State income tax laws and if all the considerations here canvassed were brought before the Supreme Court, a different decision might be reached as to the validity of the distinction between residents and nonresidents with respect to the allowance of personal exemptions.

286 App. Div. at 703, 146 N.Y.S.2d at 181-82.

Such a refinement in a state's policy of allowing personal deductions to nonresidents would not call for herculean effort. It would require only a series of specific determinations concerning the particular deduction under consideration.[170] One might deny a deduction for real estate taxes paid on out-of-state property but allow one, at least in part, for sales taxes on personal purchases in the state.[171] One might allow or disallow a deduction for interest paid on a personal loan depending on whether the purpose of the loan was peculiarly related to the taxpayer's activity in the state.[172] A strong case can also be made for at least partial allowance of medical expense deductions to nonresidents. Not only may such expenses "be regarded as related to all of the taxpayer's activities, wherever engaged in . . ."[173] but also they arguably relate to his income producing ability in the state: "[I]n effect, his medical expenditures are made in part in an effort to enable the taxpayer to continue to be income-producing, without regard to where the income may be produced."[174] Although one might dismiss the latter rationale as a quibble over the classification of medical expenses as business or personal deductions,[175] it does suggest the illogic of classifying medical expenses as "personal" and denying them simply on the basis of the label affixed.

In short, while the complete denial of personal deductions to nonresidents by the taxing state may be constitutionally permissible, and in many cases justifiable, a state could adopt a more discriminating and equitable approach to the problem without great difficulty.

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[170] This is precisely what Solomon, *supra* note 155, at 115-20, did with respect to deductions allowed under the New York State income tax law as it then stood. The present statute allows the nonresident a proportionate share of his itemized deductions. N.Y. TAX LAW § 635 (1966).

[171] *Compare* Anderson v. Tiemann, 182 Neb. 393, 404-08, 155 N.W.2d 322, 330-32 (1967) (upholding denial of "food sales tax credit" to nonresidents on ground that "food purchases for personal use are so closely related to the state of residence . . . that any . . . credit . . . should be allowed only by the state of residence . . . .").

[172] *See* Solomon, *supra* note 155, at 117.

[173] *Id.* at 118, *quoting* FEDERAL BAR ASSN. OF NEW YORK, NEW JERSEY AND CONNECTICUT, REPORT ON NEW YORK STATE TAXATION ON INTRA-STATE INCOME OF NON-RESIDENTS 11 (1958).

[174] *Id.*

[175] The court in Berry v. State Tax Commn., 241 Ore. 580, 397 P.2d 780 (1964) *appeal dismissed*, 382 U.S. 16 (1965), while denying the nonresidents' claim that they be allowed to deduct medical expenses on the ground that the "facts indicated that the income was not dependent upon the health or earning power of the taxpayers," nevertheless explicitly left open "the question whether or not in a proper case medical expenses might be 'connected with' income." 241 Ore. at 582, 397 P.2d at 781.

3. *The Standard Deduction*

The vast majority of state income tax statutes provide the taxpayer with the option of taking a standard deduction, based on a percentage of his income up to a fixed dollar limit, in lieu of itemized personal expense deductions.[176] While nonresidents are generally permitted to elect the standard deduction,[177] they are not treated uniformly under the various statutory provisions, which may be divided into two groups. The first group treats the nonresident as if he were a resident, but with respect only to his in-state earnings: The nonresident is allowed to apply the statutory percentage to his in-state income up to the established dollar ceiling.[178] The second group requires the nonresident to prorate his standard deduction, calculated on his income from all sources, in the proportion that his in-state income bears to his income wherever earned.[179]

There can be little complaint about the first type of provision. Since the state has decided to use a percentage of income as the appropriate measure of the deduction, it may quite reasonably limit the scope of the deduction to the income over which it has tax jurisdiction. In this way both resident and nonresident receive identical treatment in terms of a rational criterion, namely, income taxable by the state. The point can be made that such a provision overrepresents the deductions to which a nonresident has a legitimate claim since it grants him the same standard deduction as a resident, who might have been entitled to a variety of itemized personal deductions unavailable to the nonresident.[180] Such criticisms, however, miss the mark. The standard deduction is by definition an effort to provide the taxpayer with a simple means of calculating the deductions that he may claim. The measure is admittedly rough and no attempt is made to draw fine lines between the specific deductions to which a nonresident is or is not actually entitled. In light of their purposes and effect, these deduction provisions are unobjectionable.

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[176] CCH State Tax Guide (All States Unit) ¶ 15-000, at 1542 (1974). A number of states, following the federal model, Int. Rev. Code of 1954, § 141, also allow the taxpayer a minimum standard deduction or a low income allowance. *See, e.g.*, N.Y. Tax Law §§ 614, 634 (Supp. 1973); Va. Code Ann. § 58-151.013(d)(2) (Supp. 1973).

[177] *See* notes 178-79 *infra* and accompanying text; *but see* Colo. Rev. Stat. Ann. § 138-1-15(8) (Supp. 1965) (nonresidents must itemize deductions, though residents may elect standard deduction).

[178] *See, e.g.*, Ala. Code tit. 51, § 385(4) (Supp. 1973); N.Y. Tax Law § 634 (Supp. 1973); W. Va. Code Ann. § 11-21-34 (1966).

[179] *See, e.g.*, Ga. Code Ann. § 92-3112(d) (1961); Okla. Stat. Ann. tit. 68, § 2362(2) (Supp. 1973); Ore. Rev. Stat. § 316.117 (1973). Such an approach is an outgrowth of the fact that many state income tax statutes use federal definitions of income and deductions as the starting point for the computation of their tax base. *See* P-H State and Local Taxes (All States Unit) § 1002 (1974). Some reduction in the standard deduction for the nonresident is thus required to reflect that portion of the nonresident's federal income that is taxable by the state.

[180] *See* text accompanying notes 162-75 *supra*.

The same cannot be said, however, with respect to those provisions that require the nonresident to prorate his standard deduction, calculated on the basis of his income from all sources, according to the ratio that his in-state income bears to his total income. These operate no differently from the provisions discussed above until the dollar amount of the nonresident's percentage standard deduction reaches the statutory maximum; however, once the ceiling applies, the nonresident is no longer treated on the same basis as the resident in terms of income taxable by the state.[181] This hardly seems equitable in light of the purpose of the standard deduction. If a percentage of income taxable by the state is a fair measure of the resident's standard deduction, why should it not also be a fair measure of the nonresident's standard deduction? The analogy to personal exemptions or itemized expenses, which arguably should be prorated,[182] is not compelling. In those instances the premise is that the exemption or deduction relates to all of a taxpayer's activities, only part of which are carried on in the taxing state, and that proration is necessary accurately to reflect in-state activity. By contrast, the standard deduction is explicitly keyed to income whose source has already

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[181] The following example illustrates the point: Assume two states have a standard deduction of 10 per cent or $1,000, whichever is less. State *A* allows the nonresident to apply the percentage and maximum directly to income earned in the state; State *B* requires the nonresident to calculate his deduction on the basis of his income from all sources and then take a proportionate deduction in the ratio of in-state income to income from all sources. The impact of such provisions on the resident and nonresident taxpayer, whether the comparison is based on the nonresident's in-state income (Resident #1) or on the nonresident's income from all sources (Resident #2), is different, as shown below:

	Resident #1		Resident #2		Nonresident	
Income from all sources	(a)	$2,500	(a)	$5,000	(a)	$5,000
	(b)	5,000	(b)	10,000	(b)	10,000
	(c)	7,500	(c)	15,000	(c)	15,000
	(d)	10,000	(d)	20,000	(d)	20,000
Instate income	Irrelevant for purpose of resident's standard deduction		Irrelevant for purpose of resident's standard deduction		(a)	2,500
					(b)	5,000
					(c)	7,500
					(d)	10,000
State *A* standard deduction	(a)	250	(a)	500	(a)	250
	(b)	500	(b)	1,000	(b)	500
	(c)	750	(c)	1,000	(c)	750
	(d)	1,000	(d)	1,000	(d)	1,000
State *B* standard deduction	(a)	250	(a)	500	(a)	250
	(b)	500	(b)	1,000	(b)	500
	(c)	750	(c)	1,000	(c)	500
	(d)	1,000	(d)	1,000	(d)	500

[182] *See* text accompanying notes 153, 156, 159-61, 169-75 *supra*.

been identified. For the state to insist that the nonresident further reduce his standard deduction below the level represented by his in-state income by calculating it as a proportionate share of his standard deduction based on his income from all sources is anomalous and, perhaps, unconstitutional.[183]

C. *Credits for Taxes Paid to Other States*

With the single exception of Alaska, every state that imposes a general income tax allows its residents a tax credit for taxes paid to other states.[184] Less than half of these jurisdictions, however, allow such a tax credit to nonresidents.[185] Furthermore, most of those states that do allow the credit to nonresidents condition its grant on the reciprocity of the nonresident's home state.[186] These credit provisions thus raise two questions relating to the equitable tax treatment of nonresidents: whether it is justifiable to deny a credit to nonresidents while granting one to residents and whether it is reasonable to condition the nonresident's credit on the existence of reciprocal legislation in his home state.[187]

The case against the constitutionality of denying credits only to nonresidents follows naturally from the preceding discussion. Because the discrimination is self-evident, the issue is whether there is an "adequate ground" for it.[188] While the Court's approval in *Shaffer* and *Travis* of provisions limiting a nonresident's deductions to those connected with income earned in the state might justify a proportional restriction on a nonresident's tax credit, one can argue that it provides no support for complete denial of the credit. Every state but one taxes its residents on income from all sources;[189] thus the denial of a credit to nonresidents virtually guarantees that they will be denied a credit for taxes paid to their state of residence but levied in part upon income earned in the state of nonresidence. It therefore cannot be suggested that such denial relates only to taxes that are not "connected" with income arising from sources in the taxing state. One can thus contend that *Travis* compels the conclusion that "[t]his type of discrimination would seem to be without adequate foundation . . . ,"[190] because it is "a general rule, operating to the disadvantage of all non-residents . . . and favoring all residents."[191]

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[183] *See* Toomer v. Witsell, 334 U.S. 385 (1948); Travis v. Yale & Towne Mfg. Co., 252 U.S. 60 (1920).

[184] CCH State Tax Guide (All States Unit) ¶ 15-000, at 1543 (chart) (1974), *see, e.g.*, Idaho Code Ann. § 63-3029 (Supp. 1973); Ill. Rev. Stat. ch. 120, § 6-601(3) (1973).

[185] CCH State Tax Guide (All States Unit) ¶ 15-000, at 1543 (chart) (1974). *See, e.g.*, Ind. Ann. Stat. § 6-3-3-3 (1972); Md. Code Ann. art. 81, § 291(a) (1969).

[186] CCH State Tax Guide (All States Unit) ¶ 15-000, at 1543 (chart) (1974). *See, e.g.*, N.M. Stat. Ann. § 72-15A-12 (Supp. 1973); Va. Code Ann. § 58-151.015 (Supp. 1973).

[187] *See* Culp, *supra* note 153, at 293-94. This is not to suggest that there are not numerous other issues raised by the variety of conflicting credit provisions. *See* Note, *supra* note 13, at 981-86; *see also* J. Hellerstein, *supra* note 11, at 620-21. The discussion here, however, is limited to the legality and fairness of the disparate treatment of residents and nonresidents.

[188] Travis v. Yale & Towne Mfg. Co., 252 U.S. 60, 80 (1920).

[189] *See* note 132 *supra*.

The conclusion, however, is far from inescapable. First, to the extent that the state of residence taxes extraterritorial income, it is arguably imposing a "personal" tax that relates only to the taxpayer's state of residence.[192] Since it is solely with respect to this "extraterritorial" income, which is in-state income to the state of nonresidence, that the nonresident has even a colorable claim to a credit, one can assert with some justification that the state of nonresidence is under no obligation to grant nonresidents a credit even though it is granted to residents. More importantly, and beyond the technically defensible arguments that may be offered on both sides of the question, there are broader considerations that should be weighed in evaluating the fairness of the denial of credits to nonresidents. Tax credits, after all, are designed principally to relieve the taxpayer of the burden of taxation of the same income by two sovereigns. To examine the credit issue in terms of a single state's treatment of the resident and nonresident may therefore be analytically myopic, however justifiable in terms of established constitutional criteria.

The critical question thus becomes whether the taxing state's denial to a nonresident of a credit that is granted to a resident burdens the former with double taxation while relieving the latter. The answer depends on whether the nonresident's home state grants him a credit for taxes paid to other states. If it does, the effect of the failure of the state of nonresidence to offer a credit will, in principle, be offset by the diminution of the nonresident's tax bill in his home state.[193] Since the allowance of credits for income paid to other states by the state of the taxpayer's residence is nearly universal, the nonresident, though denied a credit for taxes paid to his home state, will nevertheless escape double taxation.[194] As a practical matter, then, the widespread practice of granting credits to residents removes or at least substantially reduces the burden potentially imposed by the denial of tax credits to nonresidents.

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[190] Culp, *supra* note 153, at 294.

[191] Travis v. Yale & Towne Mfg. Co., 252 U.S. 60, 81 (1920).

[192] *See* text accompanying notes 65-68 *supra*; *see also* Fisher, *supra* note 68.

[193] Because of the differences between state tax systems in terms of taxable income, deductions, rates, and the like, and because of the statutory limitations on the amount of the tax credit permitted under various provisions, the correspondence between one state's tax and another state's credit is often less than precise. *See* Note, *supra* note 13, at 981-86.

[194] The nonresident whose home state imposes no income tax would not confront the double taxation problem in the first place.

One might assert, however, that the determination whether there is an unconstitutional discrimination against nonresidents cannot rest on so ephemeral a basis as the existing pattern of state legislation. Yet, in light of the inconclusiveness of the constitutional dialogue on the issue,[195] it is not unreasonable to refrain from condemning these provisions in the absence of some indication that nonresidents are in fact being prejudiced under them.[196] While there are inequities resulting from the "conflicting crediting devices and the wide variation in their scope,"[197] they are not problems that grow out of explicit differences in the treatment of residents and nonresidents in statutory provisions. They are instead a function of a multiplicity of independent taxing jurisdictions whose statutes were not designed with the plight of the multistate taxpayer as their principal concern. Such problems can best be solved by greater uniformity in state legislation.[198]

VI. CONCLUSION

Two of the principal problems that legislators confront in considering tax legislation are how to raise sufficient revenue to meet the community's needs and how to do so in a manner that corresponds to the community's sense of fairness. These problems are often exacerbated when they must be solved in the framework of a multistate system where all taxpayers do not enjoy the same jurisdictional relationship to the taxing state. The initiative taken by Vermont and several other states with respect to the taxation of a nonresident's income at rates determined by income from all sources suggests that many states have the rare opportunity to provide for additional revenue in a manner that arguably makes the system fairer than it was before. The considerations underlying the state's jurisdiction to tax the income of residents and nonresidents also suggest relevant, but not necessarily dispositive, criteria for determining the appropriate treatment of nonresidents under provisions in state income tax statutes relating to exemptions, deductions, and credits.

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[195] *See* text accompanying notes 188-92 *supra*; with respect to the justifiability of conditioning the nonresident's credit on reciprocal legislation in his home state, *compare* Bachrach v. Nelson, 349 Ill. 579, 596, 182 N.E. 909, 915-16 (1932) *with* Clement v. Stone, 195 Miss. 770, 13 S.2d 647, *affd.*, 195 Miss. 774, 15 S.2d 517 (1943). *See also* Culp, *supra* note 153, at 294; Starr, *supra* note 19, at 400-03.

[196] *See* Consolidation Coal Co. v. Bailey, 467 F.2d 1124, 1126 (3d Cir. 1972).

[197] J. HELLERSTEIN, *supra* note 11, at 620; Note, *supra* note 13, at 981-86.

[198] Note, *supra* note 13, at 993-94.

PREPARED STATEMENT OF GOV. WILLIAM A. O'NEILL

Mr. Chairman, Honorable members of the Finance Committee: I want to thank the chairman, Senator Bentsen, for holding this hearing today, and for allowing me to testify.

I am pleased to join my colleague, Governor Kean, in opposing a New York tax that reaches across the borders of our states to tax Connecticut and New Jersey families. Moreover, it is always a pleasure to be in the good company of my friends, the fine Senators from Connecticut. Senator Dodd. Senator Lieberman. I appreciate your remarks and your support here today.

Senator Bradley's bill, which has been co-sponsored by Senators Lautenberg, Dodd and Lieberman, recognizes the regional problems that can occur when neighboring states get involved in cross-border taxation and the inevitable consequence: unproductive tax disputes.

Connecticut residents this spring have been adversely and in my opinion—unfairly affected by changes in New York State's income tax. Where New York had formerly taxed income earned by Connecticut residents working in New York, certain changes approved in 1987 extended the reach of the New York tax to account for income not earned in that state. It is this extension which this bill would redress through a moratorium and study.

I do not dispute the right of a state to tax the income of non-residents earned within that state, even though Connecticut does not tax earned income. What I do dispute is the right of a state to reach income earned out of state by non-residents, or to use out-of-state income as a basis for increasing the tax rate at which in-state income is taxed.

The issue of a state's ability to tax is one of fundamental fairness. Connecticut, like every other state, uses its tax dollars to provide much needed services to its residents, and for others. I strongly believe that taxes paid should have a rough relationship to the use of state services.

During this period of time, when many states, including Connecticut, are struggling to meet costs of providing programs and services to our citizens, it is especially intolerable for residents of Connecticut to be asked to pay a disproportionate share of taxes for New York's services.

I believe the issue here goes beyond dollars and cents. The issue here is one of fairness and federalism. While New York points to that fact that—for the moment—its tax changes have reduced the overall tax burden of everyone paying its income tax, that discounts the fact that it may be attributed unfairly. And, the tax is always subject to increase.

If this moratorium is approved, it is clear Connecticut and New Jersey residents will be paying a smaller proportion for New York's services than they are today.

And, let me state for the record, I understand the attraction of taxing non-residents. It is politically appealing. However, we in Connecticut decided against a retaliatory commuter tax aimed at New York residents who work in our state. While we said no this year, I can't guarantee that we will continue that stance in future years if our problem with New York's tax is not redressed.

Governor Cuomo recently informed me that he will seek technical changes to his state's law that imposed taxes on unearned income in our state, and possibly refund to some taxpayers money they should not have paid under New York's complicated law. I commend him for that action. It is a good first step towards resolving this dispute.

Nevertheless, it is appropriate to stop this process of cross-border taxation before it leads to a destructive relationship among states when regional cooperation is necessary if we are to provide a full array of services to all our residents. Legislation like New York's can only erode those relationships, and make cross-border tax wars more likely.

As Connecticut's Governor, I firmly believe our state has been responsible in raising from our citizens the taxes it takes to provide services for Connecticut's residents, as well as maintaining our transportation network for others who seek to visit or work in our state. Retaliatory taxes such as the ones considered by our General Assembly are really designed for retribution, not as revenue measures. That is not something I would like to see, but we are all human and we all can get frustrated.

No state should be subject to incursions from other states against citizens whose hard earned tax dollars should fund services in their own state.

In conclusion, I would like to make clear that, as a Governor, I usually would not request the Congress of the United States to intervene in matters of state taxation. However, in this case, Congressional action provides the only effective recourse for a just resolution of a dispute between states. I urge your committee to take favorable action on measures that will aid the taxpayers in my state.

Thank you.

Prepared Statement of Joseph C. Small

My name is Joseph C. Small and I am counsel to the Newark, New Jersey law firm of McCarter & English. For more than ten years, I have devoted my time almost exclusively to the field of state taxation.

I am pleased to testify in support of S. 800, an innovative approach to resolving an immediate, recurring and increasingly important problem in Federalism:

HOW SHOULD STATES TAX THE INCOME OF INDIVIDUALS WHO LIVE IN ONE STATE AND WORK IN ANOTHER?

There are any number of possible constitutional solutions which involve various formulae for calculating the income to be taxed, the tax rates at which that income will be taxed, and the credits (if any) to be allowed by one state for taxes paid to the other state.

The problem is determining which of the many constitutional alternatives is most fair both to the involved taxing authorities and taxed citizens. As New York's recent legislative changes indicate, the unilateral selection of one possibly constitutional alternative can have substantial adverse consequences on non-resident individuals without their having had an opportunity to make their views known to a legislature elected without their votes. The reaction to such an action—cries of "taxation without representation" and calls for retaliatory taxes—increases the volume of discussion without enhancing the substance of that dialogue. S. 800 attempts to give the governors and state legislatures some time and space to think and to breathe by creating a *moratorium* on such unilateral tax regimes and also attempts to shed light on the problem through the deliberations of a *blue ribbon presidential commission.*

I approach this problem from a unique perspective. If you'll permit me to digress a bit, I'd like to share that background with you, for I think it may help you to focus some of your questions and give some credibility to my support for this bill.

I was born in New York City and lived there for 28 years before moving to New Jersey 18 years ago. I have lived and worked (and to the extent it is not work, practiced law) in both states, commuted in both directions, and filed resident and non-resident state income tax returns in both states. For four years, from 1977 through 1981, I spent a good part of my time as a New Jersey Deputy Attorney General defending the constitutionality of New Jersey's Emergency Transportation Tax,[1] (ultimately declared unconstitutional) Several years later (1983 through 1988) as Counsel to the New Jersey Division of Taxation, I helped negotiate and implement a first in the nation bi-state sales tax agreement between New York and New Jersey.

My efforts in defending the Emergency Transportation Tax helped assure a *substantial transfer of tax revenue from New York to New Jersey.* My efforts directed at implementing the New York/New Jersey Sales Tax Agreement resulted in *increased revenue for both states.* Though the earlier effort might have been more satisfying from a gladiator's point of view, the latter was clearly more rewarding for a public servant interested in good government, good tax policy, good intergovernmental relations and creating the appropriate incentives for citizens to pay fair taxes, fairly and everheartedly administered and fairly apportioned between the states.

S. 800 gives the actors involved the opportunity to cooperate and reach an enlightened consensus. The absence of S. 800, similar legislation, or a voluntary commitment by the states to establish such a commission, will return us to the state of nature we are currently in where one state may win and one may lose. The decision will be made by a judge, based on constitutional grounds, with little concern given to the impact of political considerations essential to achieving a consensus on the appropriate solution. S. 800 gives us an opportunity for the political process to work in what is clearly a political arena. Precisely where the balance of tax bases, tax rates, and tax credits lies is not a matter for judicial, or I submit congressional determination, it is a matter for the states to work out. S. 800 provides the necessary incentives and structure to start on that course.

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[1] A tax imposed by New Jersey on New York residents working in New Jersey at New York's tax rate. During that period, New Jersey imposed at first no tax and then a much lower tax on its residents. Because of the crediting provision of the New York statute, the New York residents paid no more tax than they would have paid, but the combined effect of the two statutes resulted in New Jersey's collecting a far greater portion of their total income taxes than did New York.

I. HOW NEW YORK AND NEW JERSEY WERE TAXING COMMUTERS.

Prior to New York's recent legislation, New York and New Jersey had a similar pattern for taxing the residents of one state who worked in the other. All income of a resident was taxed in the state in which he lived at progressive rates. The state in which the individual worked, but did not live, taxed the resident's income derived from sources within that state. No consideration was given to income of that individual or his spouse, if it was earned in a state other than the state in which he worked. Additionally, the resident's state permitted a credit for the tax paid to the state in which the individual worked. The net effect of these tax bases, rates and credits was as follows:

1. An individual paid tax on his earnings to the state in which he worked at the rates of the state in which he worked based solely on what he earned in that state.
2. Tax on all other earnings was paid to the state in which the individual lived based on all of his earnings with a credit given for the taxes paid to the state in which he worked for the taxes on his wages paid to that state.

If the work state's tax rates were higher than the resident state's tax rates, then no tax was paid on the earned income to the resident state. If, on the other hand, the resident state's tax rates were higher than the work state's tax rates, then after paying tax to the work state on his wages, the individual would pay the difference in the two tax rates on his wages to his residence state.

II. WHAT NEW YORK'S NEW LEGISLATION DID

Ignoring for purposes of our discussion the special 1988 2% surcharge on unearned income of high income individuals and other smaller technical matters (which just last week Governor Cuomo of New York requested the New York legislature to repeal) New York's new system of taxation adopts the so-called California method of taxing non-residents. This method is employed by California and a dozen other states. Under this method of taxation, the tax rate imposed by the state of nonresidence is based on the worker's entire income. Thus, two New Jersey residents working in New York with identical wages will pay different taxes to the State of New York as a consequence of income derived from such non-New York sources as a spouse's wages earned in Connecticut or dividends and interest on non-New York investments.

The theoretical basis for New York's enactment of such a taxing regime is that the individual with income outside of New York has a greater ability to pay taxes and, thus, should pay taxes at the higher progressive rates attributable to that additional income. The theoretical argument opposing such a regime is that the two individuals who do not live in New York and earn identical wages there derive identical services from the state of non-residence and should, accordingly, pay identical tax.

It is not a function of your deliberations today to decide which of these two philosophical theories is correct. Rather, it is your opportunity to provide a forum to discuss these two philosophical theories and, hopefully, to arrive at a theory of taxation which is acceptable to all of the affected states.

III. WHAT IS THE PROBLEM? WHAT ARE THE ISSUES?

The key question facing all of the lawmakers is the one initially stated. *What is the fair way of taxing individuals who live in one state and work in another?* But the key issue faced by this panel is, *how is the answer to that question to be determined?* The consensus of those responsible for submitting S. 800 is that that decision may not, cannot, and should not be made by one state acting on its own, or by a Judge deciding whether what one individual state has chosen to do meets or fails constitutional tests. The issue is how best to arrive at that solution and I think the best way to do that is to provide a mechanism for the consultation of the representatives of the affected states and their residents to deliberate and to come up with a proposed solution and to submit that solution to the separate legislatures of the affected states with the hope that they will be adopted.

IV. WHAT IS THE RANGE OF SOLUTIONS?

The possible resolution of the question of determining how states should tax the income of individuals who live in one state and work in another is broad.

A. There could be a *Federal statute* prescribing a method, or proscribing certain methods. For example, a bill introduced by Representative Frenzel, currently pending in the House Ways and Means Committee, would provide the method for state tax allocation of corporate income between states.

B. There can be *unilateral state action* which is best evidenced by New York's recent legislative enactment.

C. There can be *litigation*, but, in general, this litigation can only test the constitutional limits of the unilateral state action on an up or down basis. The litigation cannot provide for a compromise between the many constitutionally permissible resolutions.

D. There can be *cooperative state action*. Perhaps the best example of this is the agreement reached almost thirty years ago by then Governors Richard Hughes of New Jersey and Nelson Rockefeller of New York. The agreement they reached resulted in the enactment of New Jersey's former Emergency Transportation Tax. In those days the Governors had significantly more control over their legislators and easily won enactment of the necessary legislation. The beauty of that agreement unraveled fifteen years later when revenues involved had substantially increased, New York no longer abided by it, and New Jersey was not politically able to voluntarily give up the revenues. The final consequence was seven years of litigation, in which I played a small part, and the ultimate declaration of the unconstitutionality of the Emergency Transportation Tax, despite the fact that the Governors and legislators in both states had agreed to the scheme twenty years before that determination. Times change—the laws change—and there is *a need for continuing, and not just a one-time, consultation.*

V. WHAT HAPPENS IF THE CURRENT PROBLEM IS NOT SOLVED?

We have before us just a few of the examples of what happens:

A. One state sues another; citizens of one state sue the other; Court time is wasted; lawyers are kept busy; but the problem is not solved.

B. Legislators introduce all kinds of retaliatory legislation. For example, there are pending in the New Jersey legislature bills to (1) replicate New York's California plan, (2) replicate the plan with modifications, and (3) reintroduce the previously declared unconstitutional Emergency Transportation Tax with modifications that its sponsors believe overcome its constitutional defects, etc. But the problem is not solved.

The net effect of this makes for active reporting in newspapers. My file on this issue dating only from February of this year, and resulting from reading only selected newspapers, is already more than one-half inch thick. But the problem does not get solved by the unilateral action of one state in an interdependent region.

VI. WHAT S. 800 DOES AND DOES NOT DO

I suggested to you before that there are a range of possible solutions to the question posed at the beginning of this statement: *How should states tax the income of individuals who live in one state and work in another?*

S. 800 does not:

A. impose a national formula;
B. impose a regional formula;
C. impose any formula.

What S. 800 does is:

A. Provide for a cease-fire or a moratorium proscribing New York's new method and any method which might be adopted in retaliation for that method.

B. Provide a mechanism to arrive at a solution through both intellectual and political deliberation by creating a commission selected through consultation with the Governors and the Senators of the affected states and the President of the United States;

C. Provide that whatever solution is agreed upon by the Commission must then be adopted by each of the affected states prior to its implementation; and, finally,

D. Assuming the commission cannot agree, or that each state does not agree to adopt the commission's recommendations, return the states to where they started, namely, where we are today—with each state's rights to act independently subject only to constitutional restraints, as imposed by the courts.

We should not be unmindful, of course, what S. 800 does immediately do is cause a small revenue loss to the State of New York.

VII. ADDITIONAL QUESTIONS

A. Why does the legislation target just New York as opposed to all states?

Because New York is where the problem is. Although the so-called California method exists in other regions of the country, nowhere has the outcry against this tax scheme been as great as in the New York City metropolitan area. Other citizens in other areas of the country may not feel as aggrieved as do the non-New York residents working in New York. If appropriate, they, too, can come forward with similar legislation for their regions.

B. Does the methodology of S. 800 result in the adoption of a national model while excluding the participation of those from other states who might be affected?

Because this is the first legislation of its type, one could easily answer the above question, yes. But, just because it is the first does not mean it should serve as an exclusive model for national adoption. The New York metropolitan area is unique with more interstate commuters moving in both directions than any other region of the nation. The interdependence of the three major states which make up this region is also greater and, accordingly, it may be necessary to have unique and special provisions in any agreement reached by these three states.

C. What are the possible conclusions of the Commission?

Without attempting to restrict the Commission but, on the other hand, suggesting some alternative, here are a few of its possible conclusions:

1. Return to the system in effect just before New York's most recent change.
2. Adopt a system, like New York's system, where each state uses the so-called California method.
3. Have a modified system, which involves a compromise between the two.
4. Take a portion of the tax paid by individuals who live in one state and work in another and put it in a special fund which is used for special interstate purposes. One such purpose might be transportation, as was the attempt of the failed Emergency Transportation Tax.

D. What is the downside to S. 800?

I think the only downside to S. 800 is the revenue loss to New York and I think what that revenue loss does is provide a substantial incentive for the Commission to adopt a viable solution.

E. What is the upside to S. 800?

I think the upside is a genuine solution perceived as fair by all and arrived at—and this is most important —arrived at by deliberations of individuals who will carry the views of all those affected by this scheme.

I have gone on far too long and welcome whatever questions you might have, although, admittedly, I have tried to anticipate and answer most of them in this statement. Despite the length of this statement, I have not covered much of what I think is important to the Committee's and its staff's full understanding of what is involved and I would simply cite you to three recent articles which I wrote describing the history of the New York/New Jersey tax wars, a more detailed description of the way New York's new system works, and some of my opinions on how and why the matter should be resolved and why it must be resolved.

"N.J./N.Y. Tax Wars Have a History," *New Jersey Law Journal*, March 9, 1989, page 6;

"New York Changes Method of Taxing Non-Resident," *New Jersey State Bar Association. Taxation Section. Newsletter*, May, 1989, page 4.

"N.Y.'s New Non-Resident Tax a Step Backward," Crane's *New York Business*, April 10, 1989, page 10.

Useful Reports of earlier attempts to resolve similar problems can be found as follows:

"Report of the Staff and Consultants to Connecticut and New Jersey on Non-Resident Taxation by New York," December 21, 1959;

State of New Jersey Commission on Out-of-State Taxation of New Jersey Residents, "A Report on Proposals Relating to the New York State Income Tax," December 23, 1959.

NEW JERSEY LAW JOURNAL, THURSDAY, MARCH 9, 1989

COMMENTARY

N.J./N.Y. Tax Wars Have a History

By Joseph C. Small*

Effective in 1988, New Jersey and other states' residents working in New York must take into account their non-New York income — i.e. the income of a spouse working outside of New York or interest and dividends with no relation to one's New York job — when calculating income taxable by New York.

The almost universal condemnation of New York's new method of taxing commuter's income has led to a series of proposals to remedy its unfairness to New Jersey and other states' residents. Everything from federal constitutional and legislative action, court challenges, and retaliatory legislation, to the mailing of tea bags to Governor Cuomo has been suggested. Though these suggestions each contain a piece of the answer, the final solution will elude us if we ignore the recent history of the New Jersey/New York tax wars and, more importantly, the tax peaces.

In the mid-1950s New York's income tax statute permitted residents to take itemized deductions in calculating their New York taxable income, but denied such deductions to non-residents (even if their entire income was earned in New York and subject to tax in New York). Charles Goodwin, a New Jersey resident, who earned all of his income practicing law in New York, challenged the constitutionality of that statute. He lost in the courts of New York, and the United States Supreme Court refused to hear the case.

As an outgrowth of that unsatisfying litigation, there was a flurry of activity; federal statutory and constitutional amendments were proposed; a New Jersey commission was established; a bi-state (Connecticut and New Jersey) report was prepared; legislation was introduced in the New York and New Jersey legislatures.

All of this bears a striking similarity to the activities we are reading about on a daily basis. The tax laws of New Jersey and New York were prospectively modified several times. Nothing settled down until the end of 1961 — six years after Goodwin filed suit — when Governor Rockefeller of New York and then Governor-elect Hughes of New Jersey reached an agreement on the appropriate method of taxing residents of New York and New Jersey who worked in the other state. That agreement included enactment of New Jersey's Emergency Transportation Tax and a system in which taxes on earnings would be paid to the state where one worked and a credit for those taxes would be allowed by the state where a commuter lived.

Period of Peace

From 1961 until 1976 there was

CONTINUED ON NEXT PAGE

The author is counsel to the Newark firm of McCarter & English. As a deputy attorney general he represented New Jersey in the tax case of Salorio v. Glaser. *As counsel to the Director of the New Jersey Division of Taxation, he led the team which negotiated the New York/New Jersey sales tax agreement.*

CONTINUED FROM PRECEDING PAGE

peace. New York and New Jersey residents living in one state and working in the other paid income tax on their earnings to the state in which they worked and paid tax on their unearned income in the state in which they resided.

In 1976, New York decided to challenge that arrangement. Whether it was because Nelson Rockefeller was no longer governor of New York, or because the number of commuters had increased, or because the amount of tax revenue flowing from New York residents to New Jersey had increased, or because the United States Supreme Court had declared a similar taxing mechanism in New Hampshire to be unconstitutional is irrelevant. What is relevant is that New York and its residents decided that they no longer approved of the agreement made in 1961 and 1962.

First, New York sued New Jersey directly in the United States Supreme Court. When that failed, individual New York residents sued New Jersey in the case of *Salorio v. Glaser*. For seven years, New York and New Jersey fought in the courts of this state and the United States Supreme Court until 1983 when the New Jersey statute which in part implemented the Rockefeller/Hughes agreement was declared unconstitutional. The constitutional defect was that New Yorkers working in New Jersey paid a tax equal to New York's while New Jersey residents working in New Jersey paid at first no tax and subsequently a lower rate tax.

The often bitter litigation used up both state's limited resources. Before the controversy was resolved the prevailing parties paid hundreds of millions of dollars to New Jersey that would have gone to New York had the statute been held unconstitutional at the time the challenge was first mounted.

An Agreement

Almost immediately after the conclusion of this second round of the income tax wars, New Jersey and New York began negotiating and ultimately entered into and implemented an unprecedented bistate sales tax agreement. Under that agreement, each state has collected tens of millions of dollars in previously avoided sales tax.

On the heels of that sales tax success, in 1987 the New York Legislature and Governor Cuomo enacted what can only be deemed an aggressive, hostile and unfair new scheme for taxing the income of non-residents. This unilateral statutory enactment has created a real problem which now confronts both our commuters and our public officials.

The easy way to solve problems is the instinctive call to "duke it out" — sue the bad guys — and let the courts decide, and/or introduce bills in Congress or in Trenton without concern for the possibility of their passage. Ultimately, the states and their citizens will have to agree, as they have in the past, on how the income of a commuter should be taxed — which state will get to tax his income, and how much each state will get.

In the current controversy, there is uncertainty as to the constitutionality of the New York law. To try and "resolve" the controversy simply by filing suit invites a long period of uncertainty. If resolving the issues of the 1950s took six years, and resolving the issues of the 1970s took seven years, will the 1980s and '90s issues take eight years?

Even assuming that New York's statute is constitutional (despite what New York officials and others are asserting that issue has yet to be briefed adequately and tried in any of the states with similar statutes) remedies must be sought to correct its obvious unfairness.

Gubernatorial politics must not interfere with resolving this important issue. If filing suit will assist in bringing New York to the negotiating table, then we should by all means file suit. But we should not abdicate to the courts the responsibility to make what is essentially a difficult political decision.

What right does New York have to consider anything other than what nonresidents do in New York when calculating their New York tax liability?

The history recounted above illustrates the following points.

- Proposing federal and state legislation without agreement between the states is mere posturing and offers little prospect of resolving conflicts.
- Suits challenging one state's tax actions take a long time to resolve although they may be essential to motivate the states to reach an agreement. Without a commitment to resolve issues beyond the scope of the suit, the suit accomplishes little in the short run.
- Careful study of a problem by experts and a political commitment to achieve a negotiated settlement are the two essential elements in resolving the controversy. Hughes and Rockefeller did it in 1961. Cuomo and Kean did it with the Sales Tax Agreement as recently as 1986.

Let Us Reason Together

The history lesson is clear. Let those with the power to resolve the problem, Governors Kean, Cuomo, and O'Neill — in consultation with the legislative leaders — appoint state, bistate and/or multistate commissions to propose a legislative resolution. The commissioners should be given a very short time frame in which to reach their conclusions and a commitment should be made to implement their suggestions.

Gubernatorial politics must not interfere with resolving this important issue. All New Jerseyans should be united on this issue. If filing suit will assist in bringing New York to the negotiating table, then we should by all means file suit. But we should not abdicate to the courts the responsibility to make what is essentially a difficult political decision.

We should assume that there is a broad range of solutions which are constitutional. There is a much smaller range of solutions that is politically acceptable, although from 1961 to 1976 the politically acceptable solution was ultimately declared to be unconstitutional. The choice of which solution is to be adopted should be made in an arena of give, take and compromise.

All the courts are capable of telling us is whether any given solution is within the accepted range of constitutionality. It is clear that New York's current proposal is outside the range of fairness and political acceptability. It is a closer question as to whether it is constitutional.

If the only way to have New York change is to have a court declare the statute unconstitutional, then let's proceed with the suit. New York would be much wiser to work with its neighbors to find an acceptable accommodation before it is left with nothing. ■

New York Changes Method Of Taxing Non-Residents

by Joseph C. Small

New Jersey residents with New York earnings face a dilemma: Pay higher taxes to New York or file a return inconsistent with New York instructions.

Prior to 1988, determining the amount of New York's personal income tax on non-residents involved the simple calculation of a tax on New York source income (i.e. wages, or earnings from an unincorporated New York business) as though the non-residents lived in New York and had no other income. For 1988 and later years a more complicated calculation considers non-New York income in computing the tax. The net result will be a higher tax because New York's higher graduated rates will be applied in situations to which they did not apply before.

Illustrating the two methods of calculations:

Facts

New York Wages	$50.000
Spouse's N.J. Wages	$40.000
Dividends & Interest	$10.000
Total Income	$100.000

Old New York Method

Calculate tax as if a resident with only $50.000 income

New New York Method

1. Calculate tax as if a resident with $100.000 income.
2. Multiply tax in (1) by a fraction.

$$\frac{\text{New York Income}}{\text{Total Income}} = \frac{\$50.000}{\$100.000} = \frac{1}{2}$$

Note that because of progressive tax rates, half the tax on $100.000 is greater than the tax on $50.000.

In adopting the new method New York joins a dozen other states, and although the new method smacks of unfairness, this author has discovered no reported case finding it constitutionally impermissible. *See*, most notably, *Wheeler v. State* 127 Vt. 361, 249 A.2d 887, *appeal dismissed* 396 U.S. 4 (1969). In fact, an old U.S. Supreme Court decision upheld the almost identical way by which New Jersey calculates its transfer inheritance tax on the estates of non-resident decedents. *Maxwell v. Bugbee*, 250 U.S. 525 (1919).

The new method of tax calculation has already stimulated at least one suit, *Hardwick et al. v. Cuomo et al.*, U.S. D.C. N.J. filed March 8, 1989, and several bills in the New Jersey legislature and Congress. The ultimate outcome of all this activity is unknown, but in the short run it has created a lot of noise, and certain dilemmas for tax practitioners.

Individuals living in New Jersey and working in New York must decide how to file their 1988 tax returns. If, for example, they take the position of the plaintiffs in *Hardwick v. Cuomo* that the new method is not permitted, it is very likely that the New York Tax Department will assess the additional tax due under the prescribed method of calculating the tax, plus penalties and interest. If, on the other hand, they follow New York's statute as written and the plaintiffs ultimately prevail, there may be no retroactive relief for taxes already paid. *See Salorio v. Glaser* 93 N.J. 447 (1983) *but see American Trucking Association v. Kline* (Tax Court of New Jersey unreported September 8, 1988). A decision must be made, based in part on the dollars involved. That amount will not be substantial for most, but not all, taxpayers.

A similar dilemma is faced by those with incomes over $100.000. New York's new law imposes a 2% surtax on the unearned income of those high income individuals in 1988. The issues are similar to those associated with the basic tax calculation. But the likelihood of its passing constitutional muster is less than that of the basic tax calculation.

Because of New York's changed method of computing its tax, there is some confusion as to how to calculate the New Jersey resident credit for taxes paid to another jurisdiction. As a general rule, that credit is limited by a fraction of:

$$\frac{\text{income subject to tax in both New York and New Jersey}}{\text{income subject to tax in New Jersey}}$$

multiplied by the New Jersey tax liability. Under New York's old method of calculation the above example would calculate the fraction as:

$$\frac{50.000}{100.000} = \frac{1}{2}$$

and reduce New Jersey Gross Income Tax liability by 50%. The New Jersey Division of Taxation has issued supplemental instructions which lead to the same result (March 6, 1989). If, however, the plaintiffs in *Hardwick v. Cuomo* are correct in their assertion that New York is now expanding its tax base, rather than simply changing its method of computing taxes, then a possible interpretation of the New Jersey credit provision would provide a different result. That result in the above example would result in the fraction:

$$\frac{\$100.000}{\$100.000}$$

The likelihood of being sustained on taking this full credit is virtually nil because it would require a court to find that New York is imposing a tax on all of a non-resident's income. That would certainly not pass constitutional muster.

Material for a new tax war between New York and New Jersey is creating uncertainty for the taxpayers and their advisors. In the short run the New Jersey taxpayers appear to be the losers and the New York State Treasury the winner. In the long run continued flight of businesses from New York to New Jersey and retaliatory measures by New Jersey may turn the tables. ■

Joseph C. Small *is associated with the firm of McCarter & English in Newark.*

New Jersey State Bar Association
Tax Section Newsletter May 1989

N.Y.'s new non-resident tax a step backward

BY JOSEPH C. SMALL

EXECUTIVE FORUM

New York's new system of taxing non-resident commuters is both unfair and shortsighted, and is likely to damage New York's economy in the long run.

Until this year, commuters paid New York state income tax only on that portion of their income earned in New York. Now, in an attempt to raise revenue and close a $2 billion budget deficit, New York will base its tax rates on the entire income of a non-resident commuter, whether or not it was earned in the Empire State.

Interest and dividend income, as well as the income of a spouse working outside of New York, will be subject to Albany's taxation. In addition, out-of-state commuters with a gross income of more than $100,000 will have to pay New York a 2% surtax on their unearned income, no matter where it originated.

Lawyers and politicians are debating whether New York's new method of calculating the tax is constitutional. It is not a completely novel scheme—but reasonable people can and do differ, and the U.S. Supreme Court could easily come down on either side.

Even assuming the high court determines the new tax computation to be constitutional, enacting it was wrong. It is not only unfair to out-of-state commuters but is also likely to drive jobs out of New York.

In the short term, the tax earns New York an estimated $50 million per year. But this short-term gain must be balanced against the long-term loss of jobs. For thousands of individuals, this will be the straw that drives them and their employees out of New York to suburban havens in New Jersey and Connecticut. With those jobs will go income tax, sales tax and jobs in service industries.

New York's high-tax image has been reinforced, and the positive publicity generated by its recent tax cuts has been squandered. The new method of calculating commuters' income eliminates much of the benefit non-residents derived from the tax cuts. It has sparked a controversy between New York and its neighbors to the benefit of other regions actively seeking to attract business from the prosperous Northeast.

The entire metropolitan area suffers when one state enacts a parochial piece of legislation. When action is taken in one state that affects the residents of others, the officials of the neighboring states must be consulted. The bickering between Trenton and Albany will only be cheered—if it's cheered at all—in other regions of the country.

It's urgent that Gov. Cuomo confer with Govs. Kean and O'Neill and agree to devise a fairer method of taxing interstate commuters, and of apportioning those tax revenues to benefit regional economies. The interests of New York, as well as those of New Jersey and Connecticut, demand nothing less.

Mr. Small is counsel to the Newark law firm of McCarter & English.

Crain's New York Business
April 10, 1989

Prepared Statement of James W. Wetzler

Mr. Chairman, members of the Committee, thank you for the opportunity to testify here today. It's a pleasure to be back at the Finance Committee after almost five years' absence.

Like other states, New York taxes nonresidents on income from New York sources—earnings, business income, gain from tangible property located in New York, and so forth. What is at issue is the rate at which we tax that income in our system of progressive tax rates. We believe that the tax rate ought to be based on the taxpayer's total income. This is called the "California method." Our critics believe that the rate should be based solely on New York source income. We do not tax nonresidents on income from non-New York sources.

I would like to address five issues that are relevant to the analysis of S. 800, which would prohibit New York from using the "California method" of taxing nonresidents for three years:

(1) The history and substance of New York's Tax Reform and Reduction Act of 1987;
(2) The equity and history of the California method;
(3) Our constitutional, legal, and practical objections to the proposal before you;
(4) The atmosphere of misinformation and emotionalism which has clouded discussion of the actual issues between New York and its neighboring states; and
(5) Finally, the proper methods of resolving the current interstate dispute.

We believe that there is no problem here that requires congressional action and that, if there were a problem, this bill would be a poor solution to it.

NEW YORK'S TAX REFORM AND REDUCTION PROGRAM

Almost all public discussion of New York's method of taxing nonresidents has occurred out of context. A single component of a major tax reform and reduction package has been isolated, analyzed, and condemned without any reference whatsoever to the package as a whole. The review has been so myopic that New York has been pilloried for tax changes that, taken together, give nonresidents a tax cut of $100 million in 1987, $101 million in 1988, and $181 million in 1989.

New York's Tax Reform and Reduction Act of 1987 contained a complete overhaul of New York's personal income tax law and provided the largest tax cuts in State history. The Act spread implementation dates and tax cuts over five years. The net result was an income tax vastly simpler, fairer, and lower some $4 billion lower by 1991.

Under our tax reform and reduction program, the top individual income tax rate is scheduled to decline from 9 percent on earned income and 12 percent on unearned income all the way to 7 percent. In 1989, the third year of the five-year program, the top rate is 7.875 percent. There is also a substantial increase in our standard deduction—to $13,000 for married couples by 1991.

In shaping reform in New York State, we followed the Federal lead, pioneered so dynamically by Senator Bill Bradley and the other members of this committee. We broadened the tax base, lowered the tax rates and stripped away a number of credits, deductions, and special provisions that had attached themselves to the tax code over the preceding decades like barnacles on the hull of a ship.

BENEFITS TO NONRESIDENTS FROM TAX REFORM

Certain features of our new tax law were particularly beneficial to nonresidents.

First of all, in 1987, New York's new tax code introduced income splitting. Prior to 1987, New York taxed married couples separately, which required a complex tax form. Now, like the federal income tax, we allow couples to file joint returns; but, unlike the Federal government, the joint return tax rate brackets are twice as wide as the single return rate brackets. Such income splitting is very beneficial to married nonresidents where only one spouse works in New York. We tax only the New York source income, but the couple gets the full benefit of the joint return rate schedule.

Second, New York conformed to the Federal base broadening reforms, such as taxation of all capital gains, elimination of tax shelters and limitation of IRAs. Part of our tax reduction was designed to offset the windfall that would have come to New York from the broader tax base. Because most base broadening changes involved unearned income, nonresidents got the full benefit of the tax rate cuts without feeling much, if any, of the sting of the base broadening.

CALIFORNIA METHOD

One reason New York adopted the California method of taxing nonresidents was that otherwise they would have received a disproportionate share of New York's tax cuts. In 1987, for example, when the first installment of the rate cuts and income splitting took effect, but before the California method took effect, nonresidents saw their taxes drop by $100 million or nine percent, while residents were seeing a much more modest two-percent cut. The combined effect of our tax reduction and reform package for 1988 and future years gives nonresidents an aggregate tax cut that is fully Proportional to that given to residents.

A second reason for the adoption of the California method is that equity and New York's progressive, "ability to pay" tax philosophy argued for doing away with artificially treating nonresidents as poor or low income individuals for tax purposes merely because they earn only a part of their income in New York State. If a person receives $10,000 of income in New York and $90,000 elsewhere, should the rate at which we tax the New York source income be based on the taxpayer's New York income, which gives the appearance of poverty, or his or her whole income, which indicates riches? Should a partner in a big eight accounting firm or a major law firm be taxed at the same rate as a low income or working class individual simply because he or she earns only ten percent of their income in New York? Our progressive, lower rates were intended to shield the poor and lower income families, not to give tax breaks to the well-to-do.

The way New York's version of the "California method" works is this:

Nonresidents first compute their tax as if they are residents. They receive the full value of all the tax reform and tax cut benefits provided to New York residents, including the greatly enhanced standard deduction, dependent exemptions, lower top tax rates, income splitting, and applicable credits. Then nonresidents utilize the income limitation percentage—the ratio of Federal adjusted gross income from New York sources to total Federal adjusted gross income—to properly allocate to New York the appropriate amount of tax to be paid. Unfortunately, much media and political commentary on our approach has focused only on the first step, where tax is computed based on total income, and ignored the second step, where tax is apportioned to New York based on the share of New York income as a percentage of the total. This has given nonresidents the erroneous impression that we are trying to tax out-of-state income.

The effect of our two-step procedure is that we apply the progressive tax rate schedule to the taxpayer's total income and apportion the resultant tax to New York, instead of apportioning income to New York first and applying progressive rates to the smaller amount of income. With flat tax rates, it would make no difference; but with progressive tax rates, the California method causes the rate at which the taxpayer's New York source income is taxed to be based on his or her total income. We believe that is a fair result.

It should be noted that 15 out of the 45 states which have an income tax use this method of calculating the tax on nonresidents. It has been upheld in the Federal appeals court. From the largest state, California, to the smallest state, Rhode Island, this method has been adopted without threats and recriminations or Federal intervention. The Federal income tax uses this method of apportioning income between U.S. and foreign sources for purposes of determining the foreign tax credit.

In addition, this method of taxation has a long history. In fact, New Jersey's inheritance tax uses this approach to tax nonresident estates on their New Jersey assets. Indeed, an important court case upholding the California method of apportionment is *Maxwell* v. *Bugbee*, (250 U.S. 525), when the U.S. Supreme Court upheld New Jersey's progressive inheritance tax.

The use of the California method to compute state income tax has also been tested in the courts and has survived court challenges The key cases are *Wheeler* v. *Vermont*, 249 A. 2d 887 (Vt. 1969) and *United States* v. *State of Kansas*, 810 F.2d 935 (10th Cir. 1987). The U.S. Supreme Court has declined to review these decisions.

As with any massive tax overhaul, there are some technical problems with the changes we enacted in 1987. Governor Mario M. Cuomo has stated that he will recommend changes to our new law when it is inequitable or is having unintended impacts. He has recently written to the Governors of New Jersey and Connecticut indicating that he will propose legislation that will address several technical problems with our new method of taxing nonresidents, and we have briefed New Jersey and Connecticut officials on that legislation.

In sum, the current situation is that New York, as part of tax reform and reduction, has adopted a tried and true method of taxation which is used by 14 other states, has been upheld in state and Federal courts, has simplified and enhanced the equity of New York's tax system, and which in 1989 results in a $181 million tax cut (16 percent) for nonresidents. Despite these facts, we have been subjected to continuous criticism from the press and elected officials in New Jersey and Connecticut.

PROBLEMS WITH S. 800

Be that as it may, you are stuck with evaluating the desirability of a solution to a problem which does not exist. If, as the White Queen told Alice, you can believe impossible things if you practice hard enough, let us assume there is a problem. The measure before you is a curious solution.

First of all, it singles out New York, and says we alone, out of 15 states, will not be allowed to use this method of taxation. How this squares with the Constitutional equality of the states in the Union is hard to fathom. Vermont will not have to stop using this method of taxing nonresidents from New York. The thousands of New Yorkers who earn income in California will continue to be required to use this method. Connecticut residents who work in neighboring Rhode Island will still be taxed under this method. Only New York must forego this method of taxation.

Second, the bill singles out one part of an integrated package of tax reduction and reform. Senator Bradley has led the nation in support of the linkage between these two goals. Do we really want to establish the precedent that it is appropriate to accept the tax cuts and then roll back the reform?

The implementation date of the proposal before you is January 1, 1988. The tax cuts for 1988 have already been granted, and taxes have been paid. Most commuters saw decreases in their tax bills. Is New York now to be required to issue hundreds of thousands of tax refunds and tax bills for 1988? In certain circumstances, typically where a nonresident has income in New York and losses elsewhere, the California method produces a tax cut. This bill would require us to impose a retroactive tax increase in these cases.

We acknowledge that the Federal Government has the authority to limit state taxing powers in certain situations. However, we believe that this authority should be used sparingly and limited to cases where state taxes threaten to interfere with interstate commerce or where the combined burden of several states' taxes on a particular taxpayer get too onerous. This clearly is not one of those situations. I am fearful that, if the Finance Committee acts on this bill, it could become a vehicle for other proposals to limit states' taxing authority. We believe Congress should be moving in the other direction, as in our vigorous support for legislation regarding state taxation of mail order sales.

MISINFORMATION ABOUT NEW YORK'S TAX ON NONRESIDENTS

I have been involved in tax policy for a long time, but only rarely have I seen so much concentrated misinformation. This controversy got carted after the Bergen *Record* printed on its front page examples of tax increases under New York's new tax law for hypothetical taxpayers. These calculations contained major errors, grossly exaggerated the tax increase cause by the California method, and neglected entirely the fact that each of the *Record's* hypothetical taxpayers gets a tax cut when both reduction and reform are considered. They printed a correction months later.

We have been charged with attempting to balance our budget and solve our revenue problems at the expense of commuters. Any attempt to link New York's new method of taxing nonresidents to our recent budget situation is demonstrably false. The Tax Reform and Reduction Act, of which this method is part, was signed into law April 20, 1987, a year when New York was experiencing a large budget surplus. Under the Act, the effective date of the "California method" implementation was deferred for one year, not to conceal it, but out of concern that nonresidents and tax practitioners have adequate time to plan for the change. At the time of the Act's adoption, a third of the 1987 tax year was already over.

We have been charged with raising taxes on nonresidents when it is clear that the net effect of the Tax Reform and Reduction Act of 1987 is a sizeable tax cut for nonresidents, one fully proportional to the tax cut for residents.

CONCLUSION

The proper way for this dispute to be resolved is for all those concerned to seek the truth and communicate it to taxpayers. I urge you to take part in that education process. If truth and an attempt to broadcast the facts is not enough to end this dispute, let the proper, nonpolitical arbitration of the courts decide the issues.

We welcome the review of the courts; we will abide by the courts' decision; and we prefer to challenge any misconceived "retaliatory" measure in the courts, not in the U.S. Congress.

Finally, let me conclude by emphasizing that no presidential commission or Congress or court can remove certain fundamental differences in the taxing philosophies of New York and New Jersey. For centuries, people have debated whether tax burdens should be based on ability to pay or on the benefits a taxpayer receives from government spending. Most tax systems embody elements of both philosophies.

The whole purpose of the "California method" is to take a snapshot of someone's "ability to pay." New York's tax system is based on an "ability to pay" theory to a greater extent than New Jersey's. As part of our 1987 tax reform, we set one goal of making sure no one under the Federal poverty level would pay New York taxes. Some 800,000 low income families, residents and nonresident, have been dropped off the tax rolls. New Jersey, in Contrast, leans more towards the "benefit" theory. Hence, New Jersey has a less progressive tax structure. This difference in tax philosophies between the two states underlies this dispute, and we are unlikely to resolve today a debate that has gone on for many years. Suffice it to say that we believe in our progressive tax system and our reliance on the "ability to pay" theory. That is why we believe the "California method" is fairer.

That is also why we do not discourage New Jersey from adopting in a constitutional manner the measure before its legislature which would implement the "California method" for the New Jersey income tax. New Jersey legislators are calling their current proposals "retaliation" and "playing hard ball." We think they should adopt the "California method" for the simple reason that it is right and just. It would be unfortunate if the correct action were taken out of spite rather than wisdom, but we would have no objections to this measure and it would make our two tax systems more similar.

The other so-called retaliatory measure before the New Jersey Assembly, the Emergency Transportation Tax, is a different matter. It has already once been declared unconstitutional by New Jersey's highest court in the case of *Salorio V. Glaser*. However, we are not asking Congress to restrict New Jersey's taxing authority. We will take our chances in the courts. We were heartened to see that a major sponsor of such retaliatory legislation has announced that he will not be pursuing it.

In closing, while we urge you not to support S. 800, the interested members of the House and Senate could play a very important positive role in having reason replace passion, substance replace rhetoric. New York, New Jersey and Connecticut cooperate very productively administering their respective tax laws. We have pioneered agreements for joint administration of sales and use taxes and exchanges of information. We will all serve the citizens of the tri-state region most effectively by getting beyond the current dispute over the California method and back towards enhancing our mutual cooperation.

COMMUNICATIONS

STATEMENT OF ROBERT P. CASEY, GOVERNOR OF PENNSYLVANIA

Thank you for the opportunity to present this written testimony on New York state's new commuter tax law and its adverse impact on the 29,000 Pennsylvanians who live in the northern tier of the state but who work in New York. As Chief Justice John Marshall warned one-hundred seventy years ago, the power to tax is the power to destroy. New York's new commuter tax threatens to destroy the long-enduring comity among the states respecting the extent to which nonresidents should bear those states tax burdens.

Under the revised law, the rate of tax is determined by the worker's total household income, including the income of a spouse who has no connection whatsoever to New York. One nonresident will pay more tax than another to New York state, not because he derives more benefit or costs more, but solely because he is married.

A simple example illustrates the inherent inequity of this law. Before the changes, if a nonresident earned $10,000 in New York state, he was taxed on the $10,000 base and paid a tax of $341. After the changes that took effect on January 1, 1988, the nonresident is still taxed on the $10,000, but the rate of taxation is now determined by looking at all of the household income, including that of the nonresident's spouse. If the same commuter who earns $10,000 in New York has a spouse who earns $90,000 in Pennsylvania, the new system more than doubles his tax liability ($750.35), even though he has drawn no more benefit from New York.

With the new tax system, New York hopes to gain $50 million each year. This increase in New York's revenue will come directly from Pennsylvania, New Jersey and Connecticut residents. The brunt of this burden will be borne by those with lower incomes, who can least afford the extra hundreds of dollars that it will cost them each year.

New York attempts to rationalize this unfair system with an "ability to pay" philosophy. But this philosophy cannot override the principle that a taxing state must provide something in return for the taxes it collects. While a taxpayer who commutes into a state to work should pay for any services that are provided by the state, there is no reason he should pay more when his spouse derives no benefit from that state. By considering non-New York income in calculating the worker's tax liability, New York is in effect attempting to obtain revenue from a source that costs the state nothing. Even Justice Oliver Wendell Holmes has decried the inherent inequity of this type of system. In 1919, he wrote; "When property outside of the state is taken into account for the purpose of increasing the tax upon property within it, the property outside is taxed in effect, no matter what form or words may be used."

As the testimony presented to this Committee graphically demonstrates, New York's cross-border tax policy has created hostility between the states and raised the specter of retaliatory legislation. If all of the states bordering New York are to provide a full range of services to residents and nonresident-commuters alike, unilateral aggrandizement like the New York system must be avoided. In the final analysis, unneighborly attempts to shift the tax burden onto nonresidents can only lead to interstate conflict.

ROBERTS & HOLLAND
July 7, 1989

Hon.
LLOYD BENTSEN,
United states Senate,
Dirksen Senate Office Building,
Washington, DC. 20510

Re: *S. 800*

Dear senator Bentsen: This letter is being submitted in conjunction with the hearings held on June 23, 1989 relating to state taxation of nonresidents.

I am offering this submission in my capacity as an attorney with fifteen years of state tax experience. I have been employed by the New York State Department of Taxation and Finance, the New York state Senate Committee on Investigations, Taxation and Government Operations; a big-eight accounting firm; two "Fortune-50" corporations; and, currently, a law firm with offices in New York City and Washington D.C. I have served as Chairman of the State and Local Tax Committee of the American Bar Association Tax Sections, as a member of the Executive Committee National Association of State Bar Tax Sections, and as a member of the Executive Committee of the New York State Bar Association.

Apparently, S. 800 was introduced to address the many problems encountered by states and individuals in the application of state personal income taxes in an increasingly mobile society. Although I am taking no position as to whether S. 800 warrants support or opposition, its introduction does provide an opportunity for comment on one aspect of state personal income taxation: multiple taxation that results from state statutory and regulatory schemes. If Congress passes S. 800 or otherwise addresses the subject of state personal income taxation, I submit that this issue should be considered.

Years ago, when the American economy was intensively manufacturing-oriented, the problem of interstate taxation of individuals was not significant. Today, however, as the American economy increasingly focuses on service industries and interstate travel becomes increasingly feasible and common, the problems become substantial.

As a consequence of the personal income tax statutes of several states, individuals are frequently taxed as residents simultaneously by more than one state. As a result, the entire income of such a taxpayer may be subject to multiple taxation. This situation is not only patently unfair, it also appears to violate the constitutional protections afforded by the due process and interstate commerce clauses.

It is clear that a state may constitutionally impose its personal income tax on the entire income of individuals domiciled within its borders.[1] It is also clear that a state may constitutionally impose its personal income tax on items of income that accrue to a domiciliary of another state if those items relate to property, employment, or business in that state.[2] It is not clear, however, that a state may constitutionally tax the entire income of nondomiciliaries, especially when such a tax results in multiple taxation.

Several states (including New York) impose their personal income taxes on the entire income of (1) domiciliaries and (2) those nondomiciliaries who meet certain arbitrary presence criteria. Specifically, state statutes generally impose a personal income tax on the "taxable income" (essentially Federal taxable income) of every resident. Some of these states define resident to include not only individuals domiciled in the state, but also individuals who maintain a "permanent place of abode" in the state and spend more than 183 days in the state. Regulations frequently define permanent place of abode to include any dwelling place (other than a place suitable only for vacations) maintained by an individual (other than for a fixed and limited time) A state regulation, recently held to be valid by a state court,[3] provides that any part of a day spent in the state (other than presence while enroute to a transportation terminal for travel outside the state) is considered presence in the state for purposes of the more-than-183 days test. Thus, under state law, an individual who is not domiciled in a state, but who rents an apartment there and spends any time during each of 184 days in the state is taxed on his entire income. If such individual also happens to be domiciled in a state or other jurisdiction with a personal income tax (e.g. Washington, D.C.), he will also be taxed by that state on all his income. Inasmuch as credits for taxes paid to "nonresident" states are usually limited to taxes paid with respect to income "earned" in the nonresident state, multiple taxation results.

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[1] *Maguire* v. *Trefry*, 253 U.S. 12; *Lawrence* v. *State Tax Commission*, 286 U.S. 276; *New York ex rel Cohn* v. *Graves*, 300 U.S. 308.

[2] *Shaffer* v. *Carter*, 252 U.S. 37.

[3] *Leach et al.* v. *Chu*, 1989 N.Y. App. Div. LEXIS 5448 (3rd Dept.).

For example, consider an individual whose domicile is clearly in Washington, D.C. where he is present for all or part of 330 days during the year. If this individual rents an apartment in New York, where he sleeps 30 nights during the year and, in addition, goes to New York for short business meetings ten times each month, both New York and Washington, D.C. will impose their personal income taxes on his entire income, including compensation for services performed in both locations, interest, dividends and capital gains. Each jurisdiction generally allows a credit for taxes imposed by the other jurisdiction, but only to the extent of compensation earned in the other jurisdiction. Other income, such as interest, dividends, and capital gains will be fully taxed by both jurisdictions.

The U.S. Supreme Court has, in recent years, repeatedly analyzed the constitutional limitations on state taxation of corporate income. As recently as this term,[4] the Court has found that to meet the requirements of the due process and the interstate commerce clauses, a state tax must pass the "four-prong test" first enunciated in Complete *Auto Transit* v. *Brady.*[5] This test requires that (1) the taxpayer have sufficient nexus with the taxing state, (2) the tax bear some reasonable relationship to the services provided by the state, (3) the tax not discriminate against interstate commerce, and (4) the tax be fairly apportioned. The due process clause additionally requires that the income, property, or transaction being taxed have some connection with the state imposing the tax.[6] Inasmuch as the constitutional protections derived from the due process and interstate commerce clauses protect individuals as well as corporations, it is important to determine whether a state's personal income tax scheme, such as that of New York, meets the tests established for state taxation of corporations.

The early U.S. Supreme Court cases clearly provide that there is sufficient connection between a state and all the income of an individual domiciled in the state to permit the state to impose its taxes on all such income. The fact of domicile or citizenship itself provides the sufficient basis for taxation.[7] Further, a state may impose its taxes on a nonresident's income that relates to property in the state or to a business or employment conducted in the state.[8] However, since there is no connection between interest or rental income on out-of-state property, for example, earned by a nondomiciliary of a state and that state, a taxing scheme that attempts to impose a tax on such income clearly fails due process requirements.

The interstate commerce clause requires that a state tax on or measured by income be fairly apportioned so that multiple taxation will be prevented. Under a scheme such as New York's, there is no apportionment; all of an individual's income is subject to multiple taxation with credits only permitted for certain types of "earned income." Thus, the New York scheme fails the "fairly apportioned" prong of the interstate commerce clause test. (It should be noted that the Supreme Court decisions that have allowed multiple taxation in the area of personal income taxes (1) focused on taxes that were actually imposed on different incidents [9] (such as the ownership of property and the receipt of income therefrom); (2) permitted multiple taxation because of an individual's being domiciled in the state [10] and (3) were decided decades before the modern *Complete Auto Transit* v. *Brady* test was established and before American society became so mobile that multiple taxation was not uncommon.)

Further, because an individual who receives income from more than one state and is taxed as if a domiciliary of each such state pays substantially more tax than an individual whose activities are limited to one state, an unreasonable burden is placed on interstate commerce. This obviously violates the interstate commerce clause.

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[4] *Amerada Hess Corporation* v. *Director, Division of Taxation*, 109 S. Ct. 1617.

[5] *Complete Auto Transit, Inc.* v. *Brady*, 430 U.S. 274.

[6] *Miller Bros.* v. *Maryland*, 347 U.S. 340.

[7] *Lawrence* v. *State Tax. Comm.*, 286 U.S. 276; New York ex rel. *Cohn* v. *Graves*, 300 U.S. 308.

[8] *Shaffer* v. *Carter. But see, Blangers* v. *Idaho Dept. of Taxation*, 1988 Ida. LEXIS 138, *cert. den.*, U.S. Sup. Ct. Docket No. 88-1266 (March 20, 1989), in which the Idaho Supreme Court struck down an attempt by the state of Idaho to tax the income of nonresident train crews. The Idaho court held that the transient presence of train crews in Idaho was not connected to economic activity undertaken in that state; therefore, application of the Idaho tax to such crews violated the nexus requirement of both the Due Process Clause and the Commerce Clause.

[9] *New York ex rel Cohn* v. *Graves*, 300 U.S. 308.

[10] *Lawrence* v. *State Tax Comm.*, 286 U.S. 276; *New York ex rel Cohn* v. *Graves. See also, Guaranty Trust Co.* v. *Virginia*, 305 U.S. 19.

It is important to note that the problem raised in this letter is not the same as the problem in the estate tax area when multiple states each claim a decedent was domiciled within their borders, and thereby tax the entire estate. There, the problem is that different "finders of fact" arrive at different factual conclusions utilizing the same legal principle of domicile. Here, the states have statutory and regulatory schemes that necessarily result in multiple taxation, even when identical factual conclusions are reached.

Although the problem of multiple taxation of individuals may or may not be solved through litigation, Congressional intervention appears appropriate because the Federal courts are hesitant to decide state tax cases, because to require individuals to proceed through litigation imposes a substantial burden, and because Congress should address an issue of such extreme unfairness. Among the many possible solutions are a federally mandated definition of residence, the establishment of competent authority procedures, and relaxation of the tax injunction act (28 USCA § 1341) for such matters.

This matter, which impacts interstate commerce so significantly, seems ripe for congressional regulation.

Sincerely,

ARTHUR R. ROSEN